August 2001

Report on the Status of Commercial Legal and Institutional Reform (CLIR) as the Foundation for Long-Term Strategy Development for the Federal Republic of Yugoslavia and Serbia

A USAID Initiative in Developing Countries

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I. EXECUTIVE SUMMARY

A. Background

On all levels, the Federal Republic of Yugoslavia (FRY) and Serbia have entered a period of extensive change and transition. Although the Balkan wars of the 1990s affected the entire region, Serbia did not experience the infrastructure damage suffered by other countries in the region (until the air strikes of 1999), but the economic sanctions imposed during the Milosevic period had a devastating impact. Serbia and FRY were unable to move forward toward a democratic, market-oriented system of government and commerce, despite having been the leading economy prior to the break-up of Yugoslavia. In short, the war, sanctions, and the Milosevic dictatorship arrested the development of the Serbian economy.

Although potentially poised to outdistance its neighbors at the end of the 1980s, Serbia has fallen far behind. The banking system is in significant disarray, with very little lending or other standard banking practices taking place. Use of gray market cash payments and other survival techniques has become the norm in the commercial sector. There is a popular perception that many or most banks are functionally bankrupt, which is also true for many of the state-owned enterprises. The new government has made many ambitious promises regarding improved conditions, but despite the numerous reforms currently commencing, has not yet been able to deliver economic change that the average person can feel.

The upside of this very negative situation is that all sectors of society are open to and want assistance in moving Serbia and FRY forward again. At the Federal and Republic levels, there are plans for extensive programs of legal, commercial, and judicial reform. Unofficial estimates suggest that 85% of the economic laws are slated for revision or replacement in the next year or two. This legislative activity is highly decentralized, with numerous ministries and departments preparing or planning legislative revision without any effective coordination. At the same time, numerous international donors and international financial institutions are preparing separate evaluations of the situation in order to offer assistance. In Belgrade, GTZ and EBRD are now conducting monthly donor coordination meetings, with Booz·Allen acting as the secretariat and possible information clearinghouse. Additional coordination will be needed, but this meeting provides a very useful forum for initial project development.

B. USAID's Program

USAID has initiated a number of programs to support the economic and legal changes needed in FRY/Serbia, including the Program for Strengthening the Environment for Private Sector Enterprise, which emphasizes the reform of the commercial law environment, and is thus also known as the "Commercial Law Reform Program" or "CLRP". This program is being implemented by Booz·Allen & Hamilton, and was started in April 2001. The objectives of the CLRP are to: provide assistance to FRY/Serbia working with policy makers and through NGOs and professional associations to support the adoption of a collateral law and registry system; institute a program to train judges in commercial law topics; assist with drafting and adoption of other laws and reforms to be identified during the first weeks of the project; and develop long-term strategies for reforming various commercial laws and institutions. By carrying out much of

this work through local NGOs, the program will strengthen the NGOs and associations involved in the process.

This report was prepared as the basis for long-term strategy development. It is based primarily on the work of Booz·Allen's Mobilization Team, which was in the field from April 23 through May 11, and supplemented by the ongoing work and analysis of the CLRP project office. The initial team consisted of Wade Channell, Task Manager and Commercial Law Specialist; Dan McGrory, Commercial Law Specialist; Peter Yanachkov, Commercial Law Specialist; Judge Charles Erdmann, Judicial Reform Specialist; and Gordon Campbell, Registries Specialist; with additional assistance later provided by Eufrona Snyder, Registries Specialist, and Yair Baranes, Collateral and Bankruptcy Law Specialist.
The purpose of the Mobilization Team was to evaluate the areas in need of legal and institutional reform in the commercial law sector, while increasing support among the government and private sector for reform of collateral law and creation of a collateral registry, and identify NGOs and associations with which the program could work to provide assistance while strengthening the organizations. This first phase ended with two workshops, one on Judicial Reform and the other on Commercial Law Reform, in order to vet the initial findings, obtain input and feedback on stakeholder needs and priorities, and build both relationships and ownership for furthering the project.

C. Initial Findings

One of the most important findings of the team was not related to any specific area of law, but to attitude. At all levels, local counterparts uniformly expressed a need for assistance and openness to receiving it. Expectations for positive change with the demise of the Milosevic regime are matched by the willingness to accept outside help in order to get back on track. In short, the stakeholders understand the severity of the problems facing them, their own limitations (especially with respect to practical experience in a market economy), and the usefulness of outside assistance.

On a more concrete side, the team also found the following:

1. Bankruptcy

One of the principle problems in the legal framework for bankruptcy is the lack of clear definitions of trigger mechanisms that would put the commencement of proceedings more firmly in the hands of creditors. At present, the Law does not clearly state when a debtor is subject to bankruptcy proceedings. In practice, proceedings may be instituted by the National Payment Bureau if a debtor fails to meet obligations within 60 days. Likewise, practice permits creditors to commence proceedings if not paid within 60 days, but even this is not clear. Different practitioners interpreted this differently, with some believing that the trigger was defined as a failure to pay a *judgment* within 60 days. In either case, the law itself is silent. The Law should permit commencement of proceedings when a debtor becomes insolvent, and then clearly define what is meant by insolvency.

To the extent that proceedings are commenced, the National Payment Bureau has been known to enforce bankruptcy requirements aggressively but not transparently. During the past ten years this enforcement has been severely tainted by political manipulation. That is, numerous bankrupt or delinquent companies were not been placed into bankruptcy if they were connected to the Milosevic regime, while others were subject to bankruptcy procedures by the Bureau without proper cause. The Law needs to provide clear requirements for when and how the State may commence proceedings, with evidentiary requirements to protect they system from such abuse in the future.

Commencement of bankruptcy actions, in a market-oriented economy, should first be within the hands of the creditors, not the state trying to determine when the creditors are at risk. Moreover, the debtor should be obligated to seek protection in certain instances in order to avoid more extreme damage to the debtor and the creditors by waiting too long to seek assistance. Neither of these conditions currently exist.

Bankruptcy practice is also weak. First, the courts need assistance in understanding the complex issues involved in bankruptcy proceedings. More importantly, however, the system lacks an effective mechanism for attachment and execution against assets. At present, only bank accounts are easily attachable through the National Payment Bureau, but the contents of the attachable accounts are generally insufficient to meet many (or any) claims. In addition, courts do not seize assets prior to judicial sale. Respondents report that judicial auctions must be announced at least two days in advance, at which point the debtor quickly removes all moveable assets, leaving the subject business as an empty shell.

Another issue with particular significance to bankruptcy is the corruption of commercial lending during the Milosevic years by political influence. Essentially, most significant loans made were not based on commercial considerations but on political manipulation, with the loans masquerading as commercial transactions. Even if the loans were secured by mortgages on property or buildings, it was understood implicitly that the lender would never be able to attach those assets for non-payment. As a consequence, mortgage-based lending has substantially ceased. Bankruptcy, as a commercial solution, is not working effectively in part because it is being applied to political problems couched as commercial problems.

2. Collateral

The Law on Obligations does not provide for the use of non-possessory pledges on moveable property. Priority of claims among creditors is based solely on possession, so that any priorities related to specific property are lost if the debtor is permitted to possess the property. Likewise, the law does not provide for registration of these interests. These provisions are by no means sufficient for the economic growth needed in Serbia and the FRY.

On the positive side, there is substantial interest in the development of a system of registered collateral interests. The team found very strong support among all groups of stakeholders in this form of credit. Indeed, the Bankers' Association immediately asked for assistance and began scheduling a workshop and other presentations at the first meeting with the team. Government ministries were also interested, but as of the writing of this report had not yet moved collateral

higher in their list of priorities. This is not necessarily a negative, however, because the amount of ground-level support may provide an opportunity for a truly demand-driven law to work its way into and through parliament. (It is also not surprising - the government is planning to introduce 40 new or amended economic laws this year alone.)

While this stakeholder interest will be critical in developing the system, it will not be sufficient. The principle obstacle to an effective system is a lack of confidence in the courts to enforce collateral contracts. For the past ten years, Serbia has been known as a debtor's paradise, with the existing law providing numerous opportunities for debtors to delay and frustrate creditors' claims. As a result, the commercial court system was accurately perceived as favoring debtors. Indeed, the Law on Obligations permits the courts to rewrite the terms of the agreement in certain instances if they find that penalties for non-payment or non-performance are too extreme, and there is no guidance for this determining when such intervention is appropriate. This institutional bias is exacerbated by a lack of understand by the courts of the impact of this approach -- judges simply do not realize that this approach destroys the credit system. Fortunately, feedback from the initial presentations and discussions on this problem suggest that there is openness to change.

3. Company

Local counterparts are acutely aware of the need to re-examine and amend the company law regime. The team found that the legal and business communities were highly interested in matters of corporate governance and how it functioned. This interest has arisen in part in the context of debate over "social ownership," a uniquely Yugoslavian ideological construct that supports claims of the employees and society regarding the ownership and management of the company. Based on these concepts, the recent privatization laws have given employees a 30% interest (down from 60% in the prior law) in privatized companies, but not necessarily through meaningful share ownership. The result has been general torpor or failure in the first privatized companies, where management is subject to will of the managed at a time when extreme changes are needed to compete in an increasingly open market.

Counterparts expressed strong interest in improved understanding of corporate governance and how it related to commercial credit and commercial transactions. The government is actively changing the environment also, having recently revised the privatization law to reduce the "social" claims by reducing mandatory employee shareholding to 30% in privatization, falling eventually to 0% for those companies that do not go private within the next three years. The international investment community has delivered very strong messages to the government and local investors that social capital does not work and is hindering investment: the government is listening.

On a more practical level, local stakeholders complained of the overly burdensome registration requirements for companies, whether for initial registration, amendments, or other required registrations. One investor noted that he was required to produce a health certificate for himself

as general manager in order to register his company.[1] There is a strong will among legal professionals and the business community to reduce the requirements in line with international standards on company registration. This will require not only legal changes, but a rethinking of the purpose of registration - Serbian tradition understands official registration as evidence of the government's approval of the company's right to exist. Most modern economies have changed their presumption: registration is not an act of *approval*, but of public notice that the owners' claim to the protections of company law (such as limited liability), permitting government to oversee and monitor company activities in the public interest. In this case, registration is only a clerical act providing notice that the company has complied with basic legal requirements for claiming the benefits of the company law regime. Serbian tradition is consistent with state-owned companies but directly conflicts with the current EU recommendations relating to company registration, licensing and regulations.

The Company Registry, although not automated, is reasonably efficient in light of its recent history, taking normally less than 30 days to process papers. A target of 2-5 days could be achieved with help on two levels. First, even without reducing the unnecessary requirements, processes could be streamlined and mechanized for substantial timesavings. Second, basic education in how to fill out the forms required would speed up the process by reducing rejected or problem filings. Judges and registry clerks complained that lawyers do not know how to register companies properly. Lawyers complained that the registry personnel do not understand the filings. In fact, truth probably lies with both camps, and the situation could be readily improved through training, including production of standard forms and "how to" brochures.

4. Competition

The Competition Law is wholly inadequate, consisting of only four pages of broad concepts set forth in 15 substantive articles. The law is best understood not as an attempt to regulate unfair competition, but as policy statement passed as a signal to investors but still awaiting proper regulation.

The Competition Agency is no better. Formerly an agency for price and market control, the change in name has not changed the function. The Agency, to the extent it operates at all, attempts to set "fair" prices instead of policing unfair practices. In short, the Competition Law and its institutional framework need complete revision.

Basic foundations do exist for Supporting Institutions. There are a number of economic and statistical research organizations that could do or learn to do the analysis necessary for economic impact, market domination, and other studies required to prosecute or defend actions for non-competitive behavior. It is not altogether certain, however, how much demand there is for change. At a popular and government level, there is much support for protecting local industry against foreign competition and even for government intervention in pricing. On the other hand, the desperate need for increased investment from the outside might counterbalance this tendency

[1] As could be expected, this unnecessary requirement for health certificates has spawned a secondary industry in a cash poor medical community -- certificates can be purchased at reduced rates without a physical examination. The requirement has thus become completely meaningless.

towards protectionism, and provide the impetus for improved competition policy, if demanded by the investor community. The danger, however, is that some new investors may seek to gain monopolistic concessions, rather than seek open competition. Thus, a solid law is greatly needed both to open and protect the economy.

5. Contract

The Law on Contracts and Torts is the only significant commercial law not currently slated for reform or amendment by the Yugoslav government. There is a good reason for this: the law is essentially sound. The Yugoslav Contract Law is based conceptually on the principle of freedom of contract and expressly permits parties to form any kind of contract not prohibited by law, even if it is not included in the existing legislation. While amendments are needed in some areas, this is not a high priority at this time.

The Commercial Courts, on the other hand, need substantial technical assistance to adjust to their changing roles and the changing rules of commercial transactions. Historically, the judiciary has not served to understand and apply the rules of modern commercial transactions, but to settle disputes between various state owned enterprises. Under the Milosevic regime, political interference with the judiciary undermined the quality of the courts at a time when they should have been learning and applying new commercial laws better suited to a market economy. The Commercial Courts are thus technically weak.

On an institutional level, the current period for processing cases is reasonable compared to neighboring countries, with average cases taking between six and eighteen months to conclude. Even so, the system could be substantially improved through introduction of modern court and case management techniques, leading the way for eventual computerization. Timing for such assistance is good, because the caseload is not yet overwhelming. The growth of private enterprise and private commercial activity, coupled with extensive changes in law, will inevitably lead to an increased caseload over time. Changes instituted now, including the introduction of domestic arbitration for commercial disputes, will help to avoid future backlogs by improving overall processing capacity.

One of the more unusual findings in the area of Contract Law is in the area of Supporting Institutions. In most European countries, notaries are an essential part of the contract system. In Serbia, they are non-existent. For contracts, this is a blessing. Notaries often obstruct reform because they hold a monopoly position over certain types of contracts and limit the freedom and flexibility of parties to the contract (as discussed further in the next section). Serbia is free from this constraint, but does not have sufficient notarial support for such actions as authentication of signatures.

In regard to the Market for Reform, the supply side of the equation is flawed. Although the law supplied is generally quite good, there is no mechanism for amending, refining or adding to the existing law based on concerns of legal practitioners, the judiciary, or commercial actors. Legislative reform is a top-down process disconnected from the demand of the constituency. In more developed systems, many programs of commercial reform tend to originate with the users, or with government agencies well-connected to user demand; at the very least, users comment

upon draft laws supposedly prepared in their interest. Public feedback on legislation in Serbia is not yet a requirement - drafters may vet their drafts, but do not have to.

6. Foreign Direct Investment (FDI)

Trade and investment are being considered separately from commercial law under a separate USAID program. (An assessment of the trade and investment regime was prepared by another contractor under separate funding.) Even so, we inevitably encountered issues related to commercial law and thus are providing brief comments on certain issues.

Two issues in particular arose during the course of our assessment. The first relates to the need for a specific Foreign Investment Code or other law. Many development and investment specialists now advise that such laws are not necessary - most countries that enjoy substantial foreign investment have no specific code for foreign investors, but have an environment favoring investment for all investors. The Ministry of International Economic Relations considered this position, however, and chose to create a special law for the express purpose of identifying the numerous laws affecting *foreign* investors as an indication of the Government's commitment to meeting their needs. The law is expected to be repealed within five years. For now, it is a message of welcome more than a necessary law.

The challenge in such laws, however, is in maintaining a level playing field for all investors. FDI laws have been used to attract outsiders at the expense of local investors who do not enjoy the same benefits, thus skewing investment patterns unnecessarily.

Second, the FDI law has marginal importance compared to the tax and fiscal regime affecting investment. Investors are concerned with their ability to gain a reasonable return on investment over the long-term, and this is directly affected by the taxes they are required to pay. Currently, the fiscal structure has a number of seemingly low taxes that in the aggregate are actually quite burdensome. Resources spent on FDI legislation will be wasted if these more fundamental issues are not addressed first.

7. Trade

Trade issues were addressed by a separate study and analysis under a different task order. Our team noted several issues, two of which are addressed here.

First, the trade regime continues to be protective of local industry. There also appears to be much support for this protection at the grass roots level. The breakdown of the old order, in which large companies had pre-arranged relations with suppliers and buyers, has left most of the public enterprises in dire straits. They have been unable to adjust to the market. Fear of bankruptcy and layoffs seem to fuel strong support for protectionism, and may limit the strength and appearance of political will for truly open trade. Highly convincing public education on the benefits of an open trade regime should be considered for all trade programs both to build support for and reduce resistance to reform.

Second, the licensing regime, though simplified, is still a constraint on companies wishing to do import and export business. On the positive side, Yugoslavia has eliminated or simplified the requirements for export and import licenses so that companies need no longer go through expensive and time-consuming application procedures for commercial import and export licenses. On the other hand, other licenses are still very cumbersome and subject to discretionary application of laws. This results in increased costs and reduced productivity, and can be a tool for unfair competition by manipulation of the licensing bureaus in favor of one actor at the expense of others.

Finally, it should be noted that a program is now underway for Yugoslavia to accede to the World Trade Organization. USAID is providing technical assistance for accession.

8. Privatization

The Privatization Law, while outside of the statement of work for this task, nevertheless intruded regularly into discussions of the commercial legal regime. Three issues were significant.

First, the success of privatization will be affected by Company Law considerations. The existence of "social capital" reduces the value of any company by more than just the 30% of the value of the shares represented. Uncertainty over the nature of the ownership also has a negative economic impact. While the government is committed to elimination of social capital over the next three years, many of the more important privatizations are scheduled to take place prior to expiration of social claims. This may be a political cost that has to be paid, but policy makers should be advised on what it is costing them in revenues or investment quality.

Second, the Privatization Law is very aggressive in its overall approach, but is insufficiently regulated. The criteria for awarding bids are not properly defined or developed. Unless the scoring is clear and transparent, the quality of bids and bidders will be compromised, and awards will be subject to unnecessary challenges.

Third, the quality of privatization is also subject to the quality of the investment climate. It is essential that the government effectively establish property rights and the mechanisms for ensuring those rights. Thus, the Law on Property, The Company Law (with emphasis on minority rights, corporate governance, and registration), Collateral Law, and the fiscal regime are some of the areas that must be addressed in concert with the privatization program in order to attract and maintain the highest quality investment.

9. Real Property

The team looked at the real property regime separately from other areas of commercial law and activity. As with the other areas, we found both positive and negative issues.

First, the law is split on the right of ownership. Rural land may be held by individuals and companies with full title, which is ideal. Urban land, however, is the property of the state. Most real estate development is or will be urban in the long run, and this dichotomy will have an

impact on economic growth.[2] Rights in urban real estate are under a cloud. Although development does not require that the state privatize all the land -- in England, 99-year leases from the Crown are used and accepted almost as readily as fee simple absolute title -- the value of any long-term leases is reduced because no one yet knows how well the state will honor its contracts. The British system is built on centuries of trust, whereas the new governments in Serbia and Yugoslavia have only months of history since the democratic defeat of Milosevic.

Second, the urban land cadastres and registries are out of sync. Many residential apartments, for example, cannot be registered, and therefore cannot be used as an enforceable security, because the apartment buildings cannot be registered. In addition, the registry system in Serbia needs to be updated and registration processes improved. Although better than the systems in many surrounding countries, the registries could profit greatly from improved processes and computerization.

Third, the fee structure for the registration of mortgages is misconceived. Fees of 2% are paid on the value of the underlying property, not on the value of the mortgage. Thus someone needing a $10,000 loan on a $100,000 property will have to pay $2,000, or 20% of the value of the mortgage, making the cost prohibitive. Some banks simply do not register mortgages because of this expense.

Finally, the Yugoslav government is currently considering a law on restitution for past confiscation of buildings and real properties, starting in the 1940s. Lessons learned from other countries that have wrestled with this problem show that the economy is best served if the law only permits compensation, not restoration of the specific land or premises to the legal owner. This, of course, requires that the method for computing compensation is reasonable to those affected, and that the repayments are actually made in a timely manner. In countries where the possessors of land could be dispossessed under restitution laws, the impact on investment in those lands has been catastrophic. By arranging for reasonable and timely compensation, the government can rectify unjust takings to some extent while limiting the creation of new injustices.

[2] Rural land is likely to undergo substantial development and investment in the short-term with new investment in agriculture and agro-industry, but urban growth and urbanization are global phenomena with long-term implications

II. INTRODUCTION

A. Background

The former Socialist Federal Republic of Yugoslavia was once seen by many as the success story of the communist countries arising after World War II. Under Marshall Iosep Tito, the federation of Bosnia, Croatia, Macedonia, Montenegro, Serbia and Slovenia seemed to successfully chart a course between the Cold War powers, playing each against the other to gain assistance, while maintaining relatively open borders and a comparatively high level of individual freedom for Yugoslav citizens. With Tito's death in 1981, this middle course, which had been based on a closed economic system bolstered by foreign assistance, began to fail, especially as the member states began to rethink their interest and commitment to membership in the republic.

By the early 1990s, the republics had either declared their independence or were moving towards independence. Ethnic tensions, historical animosities, and myriad other factors led to the Balkan Wars of the 1990s which were vigorously prosecuted by Serbian, and later Yugoslav, president Slobodan Milosevic. The former Yugoslavia eventually became a somewhat tenuous federation of Serbia and Montenegro under the name of the Federal Republic of Yugoslavia (FRY). In attempt to restore peace to the region, the international community placed the FRY under economic and political sanctions, isolating the country and its component republics for the better part of a decade.

Following democratic elections in September 2000, Milosevic was forced from office in October of that year, and was replaced by Vojislav Kostunica. Under President Kostunica, FRY has actively sought to rejoin the international community. As a result of these political and policy changes, supported by a Western-oriented government at the Serbian level, the European Community and the United States began to renew relationships with FRY and the economic sanctions imposed in the 1990s were removed. With the arrest of Milosevic in April, followed by his extradition to the Hague in June, the donor community has pledged and begun to provide substantial assistance to Serbia, Montenegro and FRY.

Although the environment is now ripe for substantial reforms, the legacy of the Milosevic years will not easily be overcome. The banking system, which was misused under Milosevic to grant loans based on political contacts rather than commercial-lending practices, is in complete disarray. Most of the existing banks are considered to be technically bankrupt and there is virtually no public confidence in domestic institutions. Countertrade, consignment by foreign suppliers, and pre-payment are principle mechanisms currently used to finance commercial activity. Investment in industry, already badly needed in the 1980s, has languished, leaving the state-owned companies non-competitive. The sanctions brought further decline as commerce was isolated and local businesses were unable to enter the import and export markets effectively. In response to these difficulties, the “gray markets” have expanded and become more firmly entrenched in society as small and medium enterprises have struggled for survival.

The negative impact of the Balkan wars and international sanctions is clearly reflected in the indicators of Chart 1.[3] Serbia once had the strongest economy in Yugoslavia, with the greatest potential for growth based on market size and resources. Today, it has a per capita GDP of only $1800, well behind Croatia ($5800), Romania ($3800), and Macedonia ($3600), while only barely ahead of Albania ($1650). From 1990-99, Serbia had a negative growth rate of 20%. Serbians know that they should be in the economic forefront of their neighbors, and are looking for change.

Chart 1. Comparative Indicators: Serbia and Other C-LIR Assessments

Broad Indicator	Albania	Croatia	Kazakhstan	Macedonia	Poland	Romania	Serbia	Ukraine
Population (millions)[4]	3.49	4.28	16.73	2.04	38.65	22.41	**9.98**	49.15
Area (km2)	28,748	56,538	2,717,300	25,333	312,685	237,500	**88,412**	603,700
1999 GDP Per Capita[5]	$1,650	$5,100	$3,200	$3,800	$7,200	$3,900	**$1,800**	$2,200
% GDP Ave. Annual Growth (1990 – 1999)[6]	2.3	-0.4	-5.9	1.9	4.7	-1.2	**-20 (1999 est)**	-10.8
% GDP - Agriculture	54	9	10	11	4	16	**20**	14
% GDP - Industry	25	32	30	28	33	40	**50**	34
% GDP - Manufacturing	--	21	23	--	20	30	**--**	29
% GDP - Services	21	59	60	60	63	44	**30**	51
Foreign Aid Per Capita[7]	$72.50	$ 8.70	$13.30	$45.80	$23.30	$15.80	**--**	$7.60
Corruption Index[8]	N/A	3.7	3.0	N/A	4.1	2.9	**2.0**	1.5
Economic Freedom Index[9]	3.70	3.50	3.70	N/A	2.80	3.30	**--**	3.60
Government Effectiveness Rating[10]	-0.653	0.150	-0.824	-0.576	0.674	-0.570	**-0.953**	-0.893
Regulatory Framework Rating	-0.700	0.236	-0.405	-0.312	0.565	0.199	**-1.539**	-0.721
Rule of Law Rating	-0.918	0.146	-0.590	-0.256	0.538	-0.088	**-0.806**	-0.707

[3] *The countries selected for Chart 1 are those studied previously under USAID's C-LIR program of diagnostic assessments.*

[4] *CIA World Factbook, July 2000 estimate.*

[5] *CIA World Factbook; 1999 estimate.*

[6] *World Development Report 2000/2001, published by The World Bank. Applies to GDP Growth and the agriculture, services, manufacturing, and industry composites of GDP.*

[7] *The World Bank: http://devdata.worldbank.org/query . Figures are from 1998 and are in current US$. As a point of comparison, foreign aid per capita in all developing countries is $8.40.*

[8] *Transparency International 2000. Scale = 1 - 10. Higher scores indicate less corruption.*

[9] *2000 Index of Economic Freedom Rankings*, The Heritage Foundation (*www.heritage.org). Scale: 1-1.95, free; 2-2.95, mostly free; 3-3.95, mostly not free; 4-5, repressed.*

[10] *Worldwide Governance Research Indicators Dataset, The World Bank. Governance indicators reflect the statistical compilation of perceptions of the quality of governance of a large number of survey respondents in industrial and developing countries, as well as non-governmental organizations, commercial risk rating agencies, and think-tanks during 1997 and 1998. Governance indicators are measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes. This footnote applies to the Government Effectiveness Rating, Regulatory Framework Rating, and Rule of Law Rating. Available at http://www.worldbank.org/wbi/governance/datasets.htm#dataset.*

On the political side, the renewed commitment to reform is substantial, but counterbalanced by uncertainty. The Federal Republic of Yugoslavia now consists of Serbia and Montenegro. Within Serbia there are three regions, Central Serbia, Kosovo, previously an autonomous region of Serbia and now an international protectorate, and Vojvodina, previously an autonomous region which is also discussing independence. There is, of course, a strong independence movement in Montenegro. Legal reform is thus clouded by issues of whether the laws should be national or federal, and if federal, whether they will be accepted and applied by Montenegro and eventually Kosovo, once its status is settled.

Even so, the Yugoslav government of President Kostunica and the Serbian government of Prime Minister Jovan Djindjic are deeply committed to reforms aimed at rebuilding the economy, attracting foreign investment, and bringing the country into candidacy for eventual membership in the European Union. The legal reform agenda is extensive and ambitious, calling for a complete overhaul of the existing system, with more than 80 laws scheduled for reform, replacement, or new introduction by the end of 2001. A new privatization law has just been adopted under a progressive program to privatize or liquidate state-owned enterprises within three years. In various international summits and investor conferences held in May 2001, the Serbian and Yugoslav governments presented an investor-friendly program of reform with hopes of attracting foreign direct investment for an economy in dire straits.

USAID is supporting the changes through a wide range of programs aimed at assisting and cementing the transformation of FRY and Serbia into a market-oriented democratic country. Returning to Belgrade after the December elections with assistance to the banking system, USAID is now working or preparing to work in the areas of privatization, commercial law, banking, WTO accession, local governance, small and medium enterprise development, rule of law, and elsewhere.

This project was designed to help strengthen the environment for the growth of private sector enterprise through commercial legal and institutional reform. Based on a preliminary assessment of the C-LIR environment, USAID contracted Booz·Allen & Hamilton in April 2001 to do the following:

1. Commercial law training for judges of the Commercial Courts
2. Establishing a collateral law and registry system
3. Assisting commercial law working groups with drafting and implementation
4. Strengthening relevant NGOs by providing assistance to and through them
5. Developing long-term strategies for commercial law reform.

This report provides the baseline for initial support efforts and for developing long-term strategy. The methodology, focus and findings are further set forth below.

B. Methodology

In preparing this analysis of the existing legal structure and long-term strategy needs for commercial legal and institutional reform (C-LIR) in Serbia and the Federal Republic of Yugoslavia, we have applied methodologies developed for USAID over the past three years.

Rather than look solely at the laws defining each area of interest, we have analyzed four dimensions that define the environment:

1. Framework Law(s) - Basic legal documents that define and regulate the substantive rights, duties, and obligations of affected parties and provide the organizational mandate for implementing institutions (e.g., Law on Bankruptcy, Law on Competition);

2. Implementing Institution(s) - Governmental, quasi-governmental or private institutions in which the primary legal mandate to implement, administer, interpret, or enforce framework law(s) is vested (e.g., bankruptcy court, collateral registry);

3. Supporting Institution(s) - Governmental, quasi-governmental or private institutions that either support or facilitate the implementation, administration, interpretation, or enforcement of framework law(s) (e.g., bankruptcy trustees, notaries); and,

4. Market for C-LIR - The interplay of stakeholder interests within a given society, jurisdiction, or group that, in aggregate, exert an influence over the substance, pace, or direction of commercial law reform, analyzed in terms of demand for and supply of legal reform.

For this task order, the team has focused on five of seven areas of law normally included in a C-LIR study: bankruptcy, collateral, company, competition, and contract. The other two - foreign direct investment and trade - are being handled under a separate task order, but we have included observations gathered in the course of this study. In addition, however, the team also expanded the scope of review to include property rights and aspects of privatization affected by the C-LIR environment.

Analysis was based on interviews with a wide variety of public and private sector representatives and study of local laws, procedures, and practices. The qualitative comments were further analyzed by reducing them to quantitative measures so that each dimension could be scored for each area of law.[11] This has allowed the team to identify specific areas of development and assistance needs.

11 *Privatization and Property were not scored because no scoring system has yet been developed for these areas and such development is outside the scope of this project. Otherwise, the same general four-dimensional approach was applied.*

C. Comparative Indicators

	Alb	FRY – Serbia	Mac	Pol	Rom	Ukr	Kzk
A. BANKRUPTCY	**38%**	**47%**	**57%**	**78%**	**54%**	**37%**	**50%**
1. Legal Framework*	90%	**61%**	87%	80%	59%	41%	60%
2. Implementing Institutions	21%	**41%**	57%	80%	62%	45%	51%
3. Supporting Institutions	16%	**39%**	42%	76%	52%	33%	49%
4. Market for Effective Bankruptcy System	24%	**48%**	41%	78%	45%	28%	41%
B. COLLATERAL	**75%**	**29%**	**74%**	**77%**	**32%**	**48%**	**35%**
1. Legal Framework	91%	**40%**	79%	90%	44%	76%	56%
2. Implementing Institutions	80%	**13%**	87%	79%	13%	56%	23%
3. Supporting Institutions	58%	**19%**	61%	65%	35%	31%	31%
4. Market for Modern Collateral System	71%	**43%**	68%	75%	37%	30%	28%
C. COMPANY	**46%**	**63%**	**55%**	**76%**	**60%**	**42%**	**57%**
1. Legal Framework	75%	**80%**	76%	70%	53%	39%	53%
2. Implementing Institutions	54%	**57%**	45%	76%	73%	52%	67%
3. Supporting Institutions	21%	**59%**	52%	82%	70%	42%	58%
4. Market for Efficient Company Law	32%	**57%**	47%	78%	43%	33%	48%
D. COMPETITION	**n/a**	**27%**	**26%**	**79%**	**57%**	**40%**	**58%**
1. Legal Framework		**40%**	57%	82%	66%	55%	64%
2. Implementing Institutions		**15%**	6%	81%	62%	42%	64%
3. Supporting Institutions		**23%**	18%	76%	51%	37%	46%
4. Market for Open, Competitive Economy		**29%**	24%	78%	49%	28%	56%
E. CONTRACT	**55%**	**61%**	**62%**	**80%**	**63%**	**45%**	**64%**
1. Legal Framework	84%	**86%**	84%	83%	74%	50%	73%
2. Implementing Institutions	51%	**63%**	62%	83%	73%	49%	66%
3. Supporting Institutions	35%	**54%**	50%	79%	66%	50%	54%
4. Market for Efficient Contract Law	50%	**42%**	50%	75%	37%	30%	62%
F. FOREIGN DIRECT INVESTMENT	**n/a**	**n/a**	**67%**	**77%**	**57%**	**41%**	**66%**
1. Legal Framework			88%	87%	96%	89%	83%
2. Implementing Institutions			62%	82%	58%	18%	68%
3. Supporting Institutions			64%	66%	38%	28%	50%
4. Market for Increased FDI			56%	75%	37%	30%	65%
G. TRADE	**n/a**	**n/a**	**63%**	**68%**	**54%**	**33%**	**52%**
1. Legal Framework			81%	93%	90%	56%	79%
2. Implementing Institutions			66%	71%	53%	34%	61%
3. Supporting Institutions			59%	49%	40%	19%	32%
4. Market for Trade Liberalization			47%	61%	35%	21%	36%
AGGREGATE TOTALS	**53%**	**45%**	**57%**	**77%**	**54%**	**41%**	**54%**
1. Legal Framework	85%	**62%**	79%	84%	69%	58%	67%
2. Implementing Institutions	52%	**38%**	53%	79%	56%	42%	57%
3. Supporting Institutions	33%	**39%**	47%	70%	50%	34%	46%
4. Market for Reform	44%	**44%**	48%	74%	40%	28%	48%

The scores shown in the above chart permit a look provide an overview of the various levels of development in FRY/SERBIA for the five areas of law studied, as well as a comparison with other countries studied using this methodology. For more useful comparisons, a few explanatory comments are necessary.

The six other countries scored in the chart were studied as part of the initial C-LIR program over a two year period, starting in 1998. The countries and dates of assessment are as follows:

Poland	October 1998
Romania	December 1998
Ukraine	March 1999
Kazakhstan	June 1999
Macedonia	June 2000
Albania	September 2000
FRY/Serbia	*May 2001*

In between the Kazakhstan and Macedonia assessments, the approach and findings of the first four studies were vetted and validated at a workshop in Prague of more than 50 legal reform specialists in December 1999. The indicators were revised, however, based on comments received at the workshop. The assessments of Macedonia and Albania used the same indicators as were used for this analysis.

Although the other countries were surveyed 1-2 years before Serbia, most of the scores have not changed substantially. Moreover, scores may have either improved (such as Romania, where the government has improved substantially in the past two years) or worsened (such as Macedonia, where war continues to interrupt legal and economic development.) Thus it is still useful to compare the countries and note some of the differences, even if not as scientifically accurate as assessments made simultaneously.

For the most part, the findings are not surprising. Having lost ten years of development opportunity through war, isolation, and sanctions, Serbia lags well behind Poland, and even falls behind its Balkan neighbors, Albania, Macedonia, and Romania. Once the leader of the Yugoslav republics, recent history has taken a toll on Serbia.

	Alb	FRY – Serbia	Mac	Pol	Rom	Ukr	Kzk
AGGREGATE TOTALS	**53%**	**45%**	**57%**	**77%**	**54%**	**41%**	**54%**
1. Legal Framework	85%	**62%**	79%	84%	69%	58%	67%
2. Implementing Institutions	52%	**38%**	53%	79%	56%	42%	57%
3. Supporting Institutions	33%	**39%**	47%	70%	50%	34%	46%
4. Market for Reform	44%	**44%**	48%	74%	40%	28%	48%

Aggregate scores are depressed, however, by the lack of collateral law and registry and the extremely weak competition law and agency. Presumably, these are areas that would have been

addressed by Serbia had it not turned away from reform under the Milosevic regime. Indeed, prior to that period, reforms were underway. The Contract Law, which received the highest score of any of the countries for Legal Framework (86, ahead of the high-scoring Albania (84), Macedonia (84) and Poland (Poland (83)), was passed in 1978 and revised several times in the 1980s by local experts without donor assistance. Albania, by contrast, adopted an entirely new legal regime starting in the early 1990s, but only with extensive outside assistance. On the other hand, both Macedonia and Albania have adopted Collateral Law regimes in the past few years, and Serbia is only now turning to this task. In light of Serbia's prior leadership in the region, the low scores can perhaps best be interpreted as a case of arrested development.

A look at Serbia's scores by themselves suggests other patterns, more fully discussed below.

DIMENSION	BANKRUPTCY	COLLATERAL	COMPANY	COMPETITION	CONTRACT	AVERAGE
1. Legal Framework	61%	40%	80%	40%	86%	**62%**
2. Implementing Institutions	41%	13%	57%	15%	63%	**38%**
3. Supporting Institutions	39%	19%	59%	23%	54%	**39%**
4. Market for Reform	48%	43%	57%	29%	42%	**44%**
AVERAGE	**47%**	**29%**	**63%**	**27%**	**61%**	**45%**

First, it can be noted that the Market for Reform is generally immature, despite a strong demand for change expressed by numerous respondents and the number of laws currently on the Serbian government's reform agenda. This is due to the nature of the indicators, which look for institutional evidence of supply and demand. In most instances, scores were quite low with the respect to the connection between policy makers and stakeholders, for there is simply no official system for involving the private sector in the legislative process. This weakness was repeated through each of the five laws studied and indicates a need for institutional reform in this area.

Second, it is clear that Serbia has the internal human resource capacity to draft quality laws. Both Contract and Company received high scores, and both were drafted by domestic specialists. The weaknesses in Bankruptcy and Competition are to be expected – neither was particularly relevant under the centrally-planned, politically directed economy that only recently opened up. Collateral, likewise, was not addressed in part because the former Yugoslavia's principle model for legal reform, Germany, still has not adopted a modern secured-financing law designed for broad-based, rapid economic growth. Given the desire to do so, Serbian drafters can be expected to obtain appropriate domestic and international assistance and do an effective job of writing new laws.

The speed of implementation of those laws will be affected both by the lack of broad-based ownership of the laws and process, as already noted, and the weaknesses in the Implementing

and Supporting Institutions. Clearly, it will not be sufficient to draft new laws for reform to take place in a meaningful manner. Courts will need assistance, as well as the numerous organizations comprising civil society that can be characterized as supporting institutions. Even so, there is good news because numerous nascent organizations exist already. There is a foundation to build on, so that it will not be surprising to find rapid improvements in these dimensions.

III. COMMON THEMES AND CROSS-CUTTING FINDINGS

Although the team focused on separate and distinct areas of the environment affecting the growth of private enterprise, many of the findings were common to all areas. Rather than repeat these cross-cutting findings throughout the report, we have opted to present them here to help establish a broad context in which the specific elements can be better understood.

A. Legal Framework

1. Connecting Supply and Demand

FRY and Serbia are presently committed to an ambitious program of legal reform in a dedicated effort to close the gap between themselves and the European neighbors who serve as their models. Drafting teams under the Serbian Ministry of International Economic Relations and the Serbian Ministry of Justice are handling the bulk of the work, and together with their Yugoslav government counterparts, have identified more than 100 needed legislative reforms. The current agenda calls for approximately 40 significant reforms by the end of 2001, a schedule that is already slipping and cannot reasonably be met.

The community of stakeholders affected by these changes - including public and private sector actors - support the reforms in general, but complains that they are not being included in the reform process. Laws are being drafted by various governmental working groups without broad public input, then presented to the government for legislative passage without additional opportunity for significant input. In short, there is no formal mechanism currently employed to connect those being who are affected by laws with those who design and adopt them.

Several examples are helpful in illustrating this point. One of the individuals responsible for drafting changes to the banking laws regularly distributes drafts to some of the banks for their input. The distribution is based on personal commitment to obtaining relevant feedback, not on a formal requirement for including the banks or other financial institutions. Distribution is selective, related more to personal connections. Should this drafter be replaced by one who prefers expediency and does not see the need for comment, even this limited vetting system can be eliminated.

Commercial Court judges raise just this issue. These judges, many of whom are members of an increasingly strong Association of Judges, including a Commercial Law Section of the Association, have noted that although they were aware of that a new Law on Courts was being drafted, they were never given an opportunity for comment and will soon be subject to decisions made by others without their feedback and input.

Lessons learned in law-making elsewhere indicate that the process of legislative reform is essential. Legislation should be the result of a democratic process of exchange and feedback as an expression of policy agreed to by the principal stakeholders and participants. Accordingly, conflicts and questions should be addressed *before* a bill becomes law so that the principal stakeholders will accept the law and support implementation. Otherwise, well-intentioned

drafters with well-intentioned laws may find that new legislation is never adopted in practice, or is even actively opposed. Stated simply, it is easier to fix a law before it is passed than afterwards. To achieve this, a method of public feedback and debate is needed.

Chart 2. A Sample of Planned Legal Reforms

Area	Targeted Law	Action Planned
Accounting	Accounting Law	New Law
Banks	The Law on Banks	Revision
Companies	Company Law	Revision
	Bankruptcy Law	Revision
	Law on Public Enterprises	Revision
Courts	Law on Courts	New Law
	Law on International Commercial Arbitration	Revision
Foreign Investment	Foreign Investment Law	New Law
	Foreign Exchange Law	Revision
Labor	Labor Code	Revision
	Law on Trade Unions	New Laws
Ownership	Property Law	Revision
Privatization	Privatization Law	New Law
	Law on Denationalization	New Law
	Law on Expropriation	New Law
Real Estate	Law on Real Estate	Revision
	Law on Real Estate Registries	New Law
Trade	International Trade Law	Revision
	Law on Trade	Revision
	Antimonopoly Law	Revision
	Consumer Protection Law	New Law
	Price Regulations	Annul

The problem also has another side. Once a law is passed, amendments are likely to be needed over time based on practical problems and issues arising from actual application of the law. Those best situated to identify commercial law reform needs are the lawyers who must interpret and apply the law on behalf of their clients, the judges who must sift through differing arguments about how the law should be applied, and the private sector business community whose businesses and profitability are affected by the legal regime. However, there is currently no mechanism for capturing the experience of these stakeholders and translating it into legislative or regulatory amendments.

For example, the Law on Contracts is generally viewed as a very good law with little need for amendment. (In fact, it is the only significant commercial law not on the legislative reform agenda.) In interviews, respondents noted that the law was acceptable, but that it might need

minor changes here and there. When asked how the changes would be brought to the attention of lawmakers, respondents were unable to identify a mechanism.

The making of law is a process that should include initial consultation with civil society and follow-up consultation with those affected by implementation. Serbia and FRY do not currently have a system to include the most important aspects of the process and therefore run the risk of the "hasty transplant syndrome" in which essentially good laws based on international (foreign) standards are adopted expediently but not accepted or effectively implemented.

On the very positive side, however, we found stakeholders and policy makers at all levels who are open to change and improvement. Most involved in the law-making process recognize the inherent importance of input, but have little experience in how to obtain it while balancing intense pressures to pass laws quickly to attract investment. A window of opportunity now exists for creating a commercial law process that connects the market demand from commercial actors and their representatives with the supply of legislation from the government.

2. Coordination and Sequencing of Reforms

Another foundational issue in the commercial law framework is also providing an opportunity for structural reform in the legislative process. Various actors involved in pushing forward the commercial legislative agenda have expressed concerns regarding the need for prioritization and coordination. Any ministry can prepare and propose draft legislation - which is appropriate - but it is now done without knowledge of whether the same or conflicting laws may be under preparation elsewhere. In addition, much of the legislative work on federal law is being done by Serbian ministries, without sufficient inclusion of those at the federal level to ensure ownership and adoption. Federal ministries have not necessarily opposed the idea of Serbian ministers doing the drafting work on federal laws, but they have certainly slowed the legislative process when they have not been included at the outset. There is a need and a desire for some entity to act as a coordinator and clearinghouse for commercial legislative reform.

With regard to prioritization, local counterparts expressed great interest in lessons learned elsewhere. A number of efforts in early legal reform programs demonstrated, for example, the importance of concentrating on basic property rights (contract enforcement, registration of pledges) before passing more sophisticated legislation such as capital markets laws. [12] While there are different ways of approaching these issues, Serbian lawmakers responsible for the reform agenda do not yet have a system for prioritizing and sequencing the almost overwhelming tasks before them. The most significant impact may be in privatization, where even a well-crafted law will not overcome the weaknesses in company and property laws that lower the overall attractiveness of privatized companies to new investors.

12 *In one of the best known examples, the Russian Supreme Court once invalidated a sophisticated law defining futures contracts in securities because the framework law for contracts did not support the new concepts. Looking at both laws and the transactions, the court determined that futures contracts were a form of illegal gambling.*

3. Enforcing Commercial Obligations

For historical reasons, enforcement of commercial obligations has not previously been a serious issue. Under the former regime, state-owned and operated companies worked with each other by mandate and did not generally need enforcement mechanisms. Obligations of individuals and companies could be handled through attachment of funds in the payment system through ZOP, the national payments bureau. The attachment of other assets was based on possessory pledges that could be converted into ownership by creditors, but only with much difficulty. The obligations of some individuals or companies involved political issues arising from patronage and influence that simply could not be handled through market-oriented enforcement mechanisms. As a result, the overall legal framework of Serbia and FRY lacks a coherent mechanism for enforcement of commercial obligations.

This gap will become increasingly burdensome as the legal system is reformed. The law governing judicial sale of assets, for example, now requires that any auction be held only after at least two days advance public notice of the items to be sold. It does not, however, allow pre-auction seizure or attachment, so that movable items up for sale usually "disappear" prior to the scheduled auction, highlighting the weakness in existing standards for company officers. There is also no legal practice of repossession for pledged property.

For bankruptcy, a credit system, collateral lending, and numerous other aspects of the commercial system to function, there must be a system of enforcement that permits timely execution on judgments. Serbia and FRY do not have such a system, and until they do many of the reforms underway will be substantially undermined. Closing this gap needs to be a high priority.

B. Implementing Institutions: The Serbian Commercial Courts

Implementing Institutions include those government bodies legally mandated to implement or oversee implementation of a given Framework Law. For Competition Law, this is usually some sort of Competition or Anti-Monopoly Agency, whereas a Trade Commission may oversee trade law implementation. For Contracts and Bankruptcy, the courts are the implementing institution. Moreover, the courts have an impact on all areas of commercial law, including those overseen by other agencies. They are the foundation of the rule of law within the commercial law framework.

Because of this importance, we have chosen to examine the Commercial Courts separately as an institution with cross-cutting importance for all areas of commercial law, instead of our traditional approach of examining the courts as the Implementing Institution for Contracts.

1. Scope of Review

The goal of the judicial sector review was summarized in the Task Order as ***"aiding the judiciary so that the Commercial Court system enforces, in an even-handed manner, rights and obligations, and protects creditors as well as debtors."*** The Task Order further discussed specific issues concerning the Commercial Courts: the bias of the legal system, particularly in

the past decade; the inability or unwillingness of the Commercial Courts to enforce critical commercial laws such as bankruptcy and liquidation; the backlog of the Commercial Courts; and the need for training of the judiciary.

For this section of the report, we have addressed the background of the Serbian/Yugoslav judiciary in general and the proposed reform efforts; the status and structure of the Commercial Courts and areas of strength and weakness; and a review of the training needs of the Commercial Courts and the local organizations, associations or institutions best suited to provide the training.

2. Background - the Judiciary under Tito and Milosevic

The current status of the Serbian judiciary can best be described as significantly damaged during the past decade by the abuses of the Milosevic regime, but not irretrievably broken. During the Tito years the Serbian/Yugoslav judiciary had a reputation for stability with a reasonable degree of independence for an Eastern European country. If a case did not have a political interest, the judges were generally left alone. Judges were politically appointed (by Parliament) and their status was that of a government employee. A judge was just another member of the state apparatus and they had no particular status in society. The courts were not independent of the executive or dominate political parties, either in judicial selection or court funding.

With the commencement of the Milosevic regime, judicial appointments became politically motivated and a number of unqualified individuals were appointed to the bench whose only qualification was party membership. The regime then utilized those judges to influence and corrupt the administration of justice. Members of the judiciary who openly objected to these actions were removed from office. The majority of judges were not involved in corrupt practices but most of those judges remained passive while the abuses occurred. The judges who were on the bench prior to the Milosevic regime and who did not take part in this corruption form a core of judges upon which the future of the Serbian judiciary must be built. It must be recognized that these judges will need massive amounts of training in the principles of a democratic government, the fundamentals of a free market system, human rights law and EU law.

3. Current Structure of the Yugoslav Judicial System

The FRY judiciary is comprised of three branches: the Federal Court (which acts as a court of final appeal for certain civil cases and serious crimes); the Federal Constitutional Court; and the federal military court system. For the Republic of Serbia, the judiciary consists of Municipal Courts (136), District Courts (30), Commercial Courts (16), the High Commercial Court (1), the Supreme Court (1), and the Constitutional Court (1).

The current leaders in the Serbian Ministry of Justice and the Serbian judiciary are acutely aware that they have been isolated for the past 10 years and have not progressed while other Eastern European countries transitioned into democratic, free market economies - with varying degrees of success. Courts in those countries have commenced reforms to recognize the rights and obligations which accompany a democratic government and a free market economy.

In February 2001 the Council of Europe sponsored a conference on judicial practice in Serbia with a view towards Serbia's eventual accession into the Council of Europe, which requires compliance with the provisions of the European Convention of Human Rights.[13] The presenters at that conference were primarily foreign expatriates and little was presented as to the current status of the Serbian court system and the local plans for reform. On 9 April 2001 the Organization for Security and Cooperation in Europe (OSCE) held a conference on judicial reform in Serbia at which most of the presenters were officials of the Ministries of Justice, local judges, prosecutors and attorneys.

The conference identified the critical issues confronting the Serbian judiciary, which were summarized into four categories: salaries; legal and structural reform; physical working conditions and equipment; and training. The conference report concluded the judicial salaries are so low ($150 - $200/month; 300 – 400 DM/month) that they have already resulted in a loss of qualified judges and, if not remedied, will lead to the loss of many remaining judges.

Attorneys in private practice attorney can earn up to 10 times the salary of judges while the more successful private attorneys can earn up to 25 times more. The Ministry of Justice (MoJ) will propose an increase in judicial salaries in the draft Law of Courts, which is currently being prepared by a MoJ working group. Salary levels have not been decided but increases to 1000 – 1200 DM are being considered and would be acceptable to the judges. It is problematic whether the necessary funding can be found from current government revenues. OSCE is exploring the possibility of providing "bridge" funding to "top-off" judicial salaries through the end of the year.

Radical changes must be made in the current Law on Courts to establish an independent judiciary, including both the independent selection of judges and financing separate from the executive branch. The draft Law on Courts contemplates judicial selection based on merit, the establishment of a Judicial Council for the selection of judges (with two thirds of the members selected by other judges), and a method for reviewing current judges and removing those who were appointed without qualification. A reduction in the overall number of judges must be also be considered, but the MoJ has not yet developed a strategy to address that issue.

Overall working conditions for the judges are poor with little technical equipment such as computers, photocopiers, fax machines, etc, all of which impede the efficiency and timeliness of the courts.

There is an obvious need for training in all areas of the law, including training in the use of technical equipment. The recently revived Association of Judges is already working in this area and the MoJ, the judiciary and the Association of Judges are also working on the establishment of a Judicial Training Institute. The Judicial Training Institute contemplates training at three levels: (1) domestic laws, (2) laws of the European Union and (3) the European Convention on Human Rights.

13 *The European Convention on Human Rights and Fundamental Freedoms is included in this analysis of the commercial law environment, as it requires an independent judiciary, the right to an impartial hearing and protects individual property rights.*

The MoJ, judicial officials and the Association of Judges are enthusiastic about the necessary reforms. There was a mixed response as to whether the necessary reforms would be adopted by parliament, but most officials interviewed believed the entire reform package (including salary increases) would be adopted this summer, effective 1 January 2002.

4. Structure and Status of Commercial Courts

The Commercial Courts are "specialized" courts in the Serbian court system as opposed to the "regular" courts. There are 16 regional Commercial Courts of the first instance and one second instance court, the High Commercial Court. At the present time the President of the High Commercial Court is a Milosevic appointee; it is expected that he will soon be removed. The third instance court in the Commercial Court system is the Serbian Supreme Court which has a division to hear appeals from the High Commercial Court.

There are approximately 220 judges in the various Commercial Courts, with the Belgrade Commercial Court being the largest with 69 judges. There are 30 judges on the High Commercial Court. The Serbian Supreme Court division which hears commercial law appeals is comprised of six judges.

The current Law on Courts clearly sets forth the jurisdiction of the Commercial Courts:

- commercial disputes between enterprises and other legal entities
- commercial disputes between domestic legal subjects and foreign individuals and legal entities
- maritime law disputes
- aviation law disputes
- trademark and copyright disputes
- cases involving status changes in enterprises and other legal entities, and
- commercial offenses.

The Commercial Courts are also responsible for maintaining company registers, bankruptcy and liquidation proceedings, the execution of decisions, and determining the validity of foreign court and arbitration decisions. [See Attachment 1] Interestingly, much of the substantive commercial law interpreted by the Serbian Commercial Courts is adopted by the federal Yugoslav parliament rather than the Serbian parliament.

The Commercial Courts are divided into 5 divisions: litigation (biggest); registration of companies; commercial law offenses; bankruptcy and liquidation; and execution of decisions. There is also an office of the court which handles court administration.

The *High Commercial Court* is responsible to:

- decide appeals from Commercial Courts
- decide first instance cases when determined by law

- decide administrative accounting disputes between state bodies
- decide jurisdictional conflicts between Commercial Courts
- monitor and harmonize court practice in the Commercial Courts
- provide opinions on practices for the trade of goods and on rules adopted by the Chamber of Commerce.

The Serbian Commercial Courts are established under the European civil law system as opposed to the common law system utilized in England and the United States. A characteristic of the civil law system is that each case is decided individually and prior decisions are not officially used as precedent. The Serbian Commercial Courts, however, have developed a hybrid system where decisions of the High Commercial Court and Supreme Court are published and can be used by lower courts as guidance. The lower courts are not required to follow these decisions but in practice usually do. This concept of "persuasive precedent" provides both attorneys and the courts with the consistency required for a stable commercial law environment.

The Commercial Courts are a microcosm of the overall Serbian court system. They suffered from the same problems as other courts under the prior regime, including the appointment of unqualified judges and the manipulation of the court system for the benefit of the government and dominate parties. In cases where political interests were not involved the Commercial Courts generally remained objective.[14]

A number of those interviewed noted a pro-debtor bias in the courts (with one calling Serbia a debtor's paradise). Much of this bias is the result of debtor-favorable provisions in current Serbian law. Because of these laws, and Serbian judicial and business traditions, a pro-debtor mentality permeates the judicial philosophy of the Commercial Courts. Despite these problems, attorneys who practice in the area stated that their domestic clients are not reluctant to submit disputes to the Commercial Court system, however foreign business clients remain less confident. The willingness of domestic clients to submit disputes to the Commercial Courts may be due to the lack of any viable alternative.

Areas where abuses commonly occurred in the last ten years were in the registration of companies, bankruptcy and liquidation.[15] Certain judges would allow individuals to improperly alter the ownership of companies in the company register maintained by the court and participate in insider trading. In addition, the liquidation and bankruptcy procedure was used to punish individuals and companies that opposed the Milosevic regime. There was also political direction from the regime that socially-owned companies in bankruptcy should not be closed. As a result, the number of pending cases in the Bankruptcy and Liquidation Department of the Belgrade Commercial Court has dramatically increased since 1999. (See Attachment 2)

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14 *One experienced commercial law attorney stated that during the sanctions he represented foreign business clients who had provided goods to Serbian companies and had not been paid. The Commercial Courts issued decisions in favor of the foreign companies.*

15 *Liquidation occurs when a business has sufficient assets to pay 100% of its debts but the management wants to terminate its existence. Bankruptcy occurs when a company cannot meet 100% of its debts and is initiated by the Payment Bureau. The triggering events are insolvency for 60 consecutive days or intermittent insolvency for 75 days. Creditors can initiate bankruptcy proceeds if they have been unable to execute on a judgment.*

Currently it is commonly recognized that "Serbia is bankrupt", meaning that most socially-owned companies are either in or should be in some phase of bankruptcy. Judges even joke about it. These bankruptcies are not actively processed since those companies employ thousands of workers and closure of the companies would cause serious social disruption. The courts feel that that this problem is more a societal problem which must be addressed in parliament rather than a problem that can be resolved by mechanically processing these companies through bankruptcy. That philosophy reflects the realities of the prior system where the courts routinely implemented the government's policy directives. While that type of political interference is unacceptable in an independent judiciary, it is just as important to change the mindset of current judges who believe that courts are just another arm of government policy apparatus. That philosophy must be changed if any meaningful reforms are to take place in the Commercial Court system.

All those interviewed agreed that the time from filing a typical complaint in Commercial Court to a final decision was 1-1 ½ years, while the quickest cases were processed in 6 months. There are examples of egregious delays in every court system and while some cases have taken 4-5 years to resolve, those cases do not appear to be the rule. During the period of hyperinflation debtors took advantage of the current system to delay the payment of debts and judgments as the longer they delayed, the less they would have to pay in real money.

An expedited procedure was adopted in June 2000 by the Commercial Courts for small claims which are based on a written document, which has increased the efficiency of the courts in these disputes. Despite these somewhat reasonable timelines, the Commercial Court procedure does appear to have some procedures which could be streamlined to speed up the process. The backlog of cases in the Company Registration Department and the Litigation Department in the Belgrade Commercial Court continues to increase. (See Attachment 3)

While the Commercial Courts had unqualified individuals appointed as judges by the Milosevic regime, the identities of those individuals are known and some have been already removed. The reforms contained in the draft Law on Courts will apply to the Commercial Courts and most of the systemic problems will be addressed and hopefully resolved in that legislation. This should remove the unqualified judges, provide the necessary independence and address the inadequate salaries.

The consensus is that the Commercial Courts are adequately staffed.[16] Under Western standards the Commercial Courts suffer from a lack of financial resources to provide for comfortable and efficient physical working conditions and support equipment, but they are in better shape than the regular courts. Nevertheless, there is very little computerization and those computers which do exist are not networked or used efficiently.

The High Commercial Court operates in a relatively efficient manner with most appeals being completed in six months. The process, however, could be more efficient in regard to company

16 *The President of the Belgrade Commercial Court stated that even if the appeal of privatization cases were assigned to the Commercial Courts, they would not need additional judges, although they would need additional funding for support and infrastructure.*

registration and bankruptcy appeals. Some of the delay experienced in the High Commercial Court is attributed to the support staff which is low paid and demoralized. For instance, a dictated decision can wait for as long as a month to be transcribed. The High Commercial Court experienced more political interference during the Milosevic regime than did the regional Commercial Courts and one High Commercial Court judge was removed by the regime for refusing to comply with the political directives.

There is currently little use of arbitration in commercial law in Serbia at the present time. Most international companies doing business in Serbia have foreign arbitration provisions in their contracts. There is an International Arbitration Court in the Yugoslav Chamber of Commerce but its decisions are treated as domestic decisions under Serbian law and as such can be challenged during the enforcement proceedings. Foreign arbitration decisions are enforceable in Serbian courts but the courts cannot review the substantive decision, making foreign arbitration preferable for foreign investors. There is no domestic arbitration structure in Serbia. The larger companies will often seek and obtain out of court settlements, but those are the result of informal efforts of the attorneys.

5. Commercial Law Training Needs

Everyone interviewed agreed that judicial training was a crucial area where a great deal of work needs to be done quickly. One of the difficulties will be the fact that many judges sincerely believe that they are up to speed on the basics of a free market economy and also believe that their current commercial law system, while inadequate, needs little change. The isolation of the commercial law judiciary from the developing legal trends in the last decade has left the judges far behind their contemporaries in other countries. Initial training for Commercial Court judges will need to concentrate on the role of a judge in an independent judiciary, the free market system, and the current status of contemporary international business practices and commercial law.

The judges need to be trained on the substantive provisions in the new commercial laws which will be adopted, but that training will find little success until the judges understand their role in both the domestic and global business environments. Training should not be limited to the judges. The legal assistants in the courts should also receive appropriate training. Attorneys practicing in the commercial law area should also be provided with training opportunities on free market commercial concepts and the new laws.

The Association of Judges will soon create a Commercial Law Section and the Association will be the natural vehicle for the training of commercial law judges until the Judicial Training Institute is created and operational. Training areas should include the role of a judge in a democracy (independent judiciary), the dynamics of a free market economy and the role of the courts in that context, modern business principles and practice, newly revised procedural laws, the new commercial laws as they are enacted, international trade laws, the European Convention on Human Rights, training on modern technical equipment as it is made available (computers), and English language training.

C. Supporting Institutions

Serbia has a strong base of Supporting Institutions compared to other transition countries studied. There are large numbers of legal and other commercial professionals who have traveled and studied abroad and have brought back a good comparative understanding of legal traditions and modern commercial transitions. They form a sizable pool of local resources that can support the reforms underway.

Even so, there are still substantial gaps in the Supporting Institutions. During recent years, most associations and organizations were highly political, not practical. Isolation under the sanctions kept them from developing strong ties with organizations elsewhere, and many business-related associations (such as chambers of commerce) were quasi-governmental bodies with mandatory membership, thus not responsive to demands of their constituencies or the market.

The team identified a number of institutions, associations, and NGOs that can already provide support to reform efforts and act as effective local counterparts for technical assistance. Others need further development, and some need substantial assistance to become effective. On the whole, there seems to be a basic openness of the local population to form associations, although not necessarily the resources to fund them. Governmental institutions, however, are generally weak.

1. Governmental Institutions

a. Bailiffs

Institutions relating to the enforcement of judgments are among the weakest of those examined for this study. Essentially, there has been little practice in the attachment or seizure of assets other than through the payment bureau which involves only bank accounts. Thus bankruptcy and contract cases requiring repossession of collateral or assets are not supported by a professional body of bailiffs or other agents who can effectively seize and deliver or seize and auction property. This gap will need to be addressed systematically in connection with the Law on Execution. Use of private persons to fulfill the functions of a bailiff should also be explored.

b. Notaries

Unlike most other European countries, Serbia has few if any notaries and very few requirements for their use. In other countries - including the former Yugoslav republic of Croatia - there is a strong tradition of notaries who provide a number of specialized services relating to the production, authentication and legalization of certain types of documents, such as company charters, contracts for the sale of real property, and other documents of high value or subject to registration. One such function is the creation of a “public document” that has the same status of a court decree without the necessity of the delays of court procedures.

However, these notarial traditions elsewhere in Europe often tend to represent a professional cartel, frequently at odds with the development of market-oriented service delivery. Notaries in a number of countries have a mandatory fee structure, monopoly rights over certain transactions,

and veto power over documents prepared by lawyers. The absence of such an institution in Serbia, therefore, is a benefit rather than a detriment.

At this point in time, there is little reason to focus on notaries. Their principle function is to provide authentication for parties who voluntarily choose to have certain transactions or documents authenticated for purposes of veracity and authenticity. This means that notaries must be responsive to market demand, rather than distorting the market through exercise of monopoly privileges.[17] Donors providing assistance in areas normally requiring some form of notarization - such as registries - should be careful to avoid creation of this kind of cartel mentality and organization.

c. Registries

For purposes of this project, the team studied registries related to collateral, companies, and real property. Each of these is discussed specifically within those sections of the report. There is no registry of non-possessory pledges of movables. In addition to the land and company registries, there are registries of ships and aircrafts, which are in compliance with international standards. Commercially-related registries not reviewed are those associated with tax, trade, exchange of securities (stocks) and credit tracking.

2. Professional Associations

a. Accountants

Accounting firms and accountants in Serbia are not yet well organized or well developed. Most respondents noted that few accountants can apply International Accounting Standards, and that substantial assistance and training will be needed to upgrade the overall level of accounting skills. Large international firms have only recently begun to provide extensive services locally due to sanctions, so even they do not yet fill this void.

This situation is not surprising. Application of proper standards by companies is generally a market response: a company must have audited or auditable books to obtain commercial credit or to effectively negotiate with a strong tax authority. In FRY, there was little commercial lending during the Milosevic years, as loans tended to be made on the basis of political connections rather than commercial standards. Tax enforcement was also politicized, but also handled through the payment bureau and not necessarily based on proper auditing. As a result, Serbian companies have not had to incur the expense of higher quality auditing. In addition, there has been no significant foreign investment, which usually requires high accounting standards.

[17] *In Croatia, for example, notaries have raised the cost of certain transactions by requiring that underlying documents be verified by themselves even if prepared by highly competent lawyers, and charging the same amount as they would for actual preparation of the documents themselves. Moreover, they have limited the number of notaries who can be licensed in each town to ensure that there is limited or no competition for prices or services. However, the notaries are providing an alternative to the time-consuming court process of creating and enforcing contracts for security interests in immovables and movables.*

Assistance in improving the level of accounting will be needed as FRY rebuilds its banking and investment structure. Such work, however, is outside the scope of this project.

b. Economists

Despite its socialist past, Serbia has developed a strong body of market-oriented economists, due in great part to the openness of Yugoslav society to foreign study and travel. One association of economists, G17+, has become highly influential as an economic and political think-tank, which can and does provide economic studies to government and private sector clients. Several state and private universities and colleges teach market-oriented economics, ensuring a growing supply of qualified economists for the future. Specialized economists - such as privatization experts - are still needed and can be supplied in the short term by donor organizations during these transition years. Over time, however, it is expected that Serbia will meet its own demand for economists through local supply.

c. Lawyers and Judges

Like many countries within the civil tradition, law in Serbia is an undergraduate field of study with a large number of students who obtain a degree without ever moving into the practice of law. Unlike some other countries, however, the supply of law students is so abundant (over 12,000 enrolled at the Belgrade Law Faculty alone, of which 4-5,000 are actively pursuing their degree), that there is also a large supply of highly dedicated legal professionals graduating each year and going on to join the professional legal community.

Lawyers in Serbia are divided into two classes: *lawyers* and *advocates*. Lawyers are those who have obtained a law degree and provide legal counsel as employees of corporations or other entities but who have not done an internship with a law firm or sat for the bar exam. They are permitted to work as in-house counsel, but are not permitted to appear in court or be members of any of the mandatory bar associations. (However, advocates who leave independent practice to become in-house lawyers are permitted to appear in court for their employers.) Advocates, on the other hand, are those who have passed the bar exam after a completing a legal internship. They may represent clients in court as well as provide numerous other legal services. This system is not unlike the British division between solicitors and barristers.

Associations of legal professionals are also divided along these lines. The bar associations are mandatory membership organizations of advocates within Serbia. There is also, however, an organization of in-house lawyers that is quite active, holding annual conferences on legal issues important to banks, corporations, and other entities who employ in-house attorneys.

Before discussing the local bar associations, it is important to clarify their structure and avoid confusion often resulting from U.S. preconceptions. In the United States, the "bar" has two distinct meanings. First, admission to the bar is a licensing requirement and refers to the internal body within a state that licenses, disciplines and oversees the professional practice of law. Membership (or dues, at least) are mandatory. The "bar" does not necessarily provide any services other than licensing, data collection, and professional discipline. A "bar association", on

the other hand, is a voluntary organization of lawyers admitted to practice (either active or retired) who pay dues in order to belong to the association and obtain services. Such organizations can provide substantial benefits, ranging from library and resource access, referral networks, continuing legal education opportunities, specialized committees and task forces, and various professional publications.

In most transition economies, bar associations are mandatory organizations more in the nature of an American state bar licensing and discipline board responsible for the regulation of the legal practice. Sometimes they also provide services to members, but because they are not accountable to membership and do not have to depend on meeting market demand for their survival, they are often seen by members as a mandatory tax with few or no benefits.

For Serbia, the bar associations are mandatory, but they are also striving to provide services in the nature of an American voluntary bar association. All lawyers admitted to practice are members of a local bar association in their region (such as Nis or Novi Sad). The Serbian Bar Association is comprised of these regional units. These associations are increasingly seeking to provide meaningful services to their members, although most members still tend to see membership as a burden rather than a benefit. It is likely that they could become important vehicles for continuing legal education and for legislative input, but need assistance in developing these services. They do provide legal commentary through professional publications, however, so there is precedent for service provision.

There is also a growing demand for voluntary associations of lawyers with specialized interests. Presently, a group of top level law firms who represent foreign investors is exploring the possibility of creating a formal association to track international standards in legal practice and provide continuing legal education and practical assistance for their advocates in order to compete with the inevitable influx of foreign law firms. To organize themselves, however, they must be careful not to run afoul of laws providing the bar associations with monopoly powers over bar association functions. Legal aspects are currently being explored. It may be that legal reform will be needed before voluntary organizations of advocates can supply the kinds of services offered by voluntary organizations in the West.

In addition to lawyers, there is a strong association of judges. The Serbian Judges Association is a mandatory membership organization comprised of the 2000 judges from the various courts in Serbia. Like other mandatory organizations, it does not have a strong record of providing services to its members in the past (other than some annual meetings), but the leaders are trying to change this. The SJA has specialized sections, including a recently formed Commercial Section that has expressed great interest in a more active role in legal and judicial reform. In addition, the SJA is seeking to provide services to the members.

The Commercial Courts do not have a separate association. Instead, they are beginning to use the Commercial Section of the SJA as a forum for their particular interests.

Sometimes frustration acts as an excellent driver for change. The Ministry of Justice recently released a draft Law on Courts, amending the prior law in various ways, including mechanisms for appointment and removal of judges. While the law may or may not be sufficient, it has

created a strong reaction among at least the Commercial Court judges because they were not included in the preparation and analysis of the law, or even given an earlier draft for review and comment. The resentment over this is likely to lead the SJA to take a more proactive role in legal reform issues affecting the courts.

d. Statisticians

The team did not directly examine the level of statistics and statisticians in FRY/Serbia. Two observations can be noted, however, which were gleaned from interviews with numerous respondents. First, Serbian professionals involved in commercial law reform are generally aware of the importance of statistics, and many institutions collect data for the purpose of publishing statistics either internally or publicly. The courts, for example, were able to provide relatively useful statistics on case backlogs and types of cases processed, and the Office for Accounting and Payments (*Zavod Za Obracun e Placenja* - ZOP) maintains a sophisticated and detailed set of statistics regarding their functions.

On the other hand, a number of respondents questioned the reliability of local statistics, especially in recent years under Milosevic. We did not attempt to verify the overall quality of statistical data, but instead note that it is under a cloud of doubt among local professions.

3. Specialized Services

a. Appraisers, Liquidators, and Bankruptcy Trustees

All of the support services related to bankruptcy and liquidation matters are weak, at best. First, the bankruptcy law as it exists has been used more as a political tool than a mechanism for orderly exit from the market by failed commercial endeavors. Moreover, the social and political implications of bankruptcy are so great that both the government and the courts have been reluctant to fully prosecute cases or to place companies - especially large state-owned enterprises - into bankruptcy proceedings. In fact, it is reported that no single bankruptcy case has been fully prosecuted yet under existing law.

Because of this situation, there has been no real demand for the various support services related to bankruptcy, such as appraisers, liquidators, and trustees. To the extent a basic corps of such professionals exists, they have had too little practical experience thus far to gain the level of expertise they need. Substantial assistance will be needed as an important adjunct of any bankruptcy law reform program.

b. Brokers

The team did not examine customs and trade issues in any depth, and therefore did not examine customs brokers and similar import/export professionals. Likewise, for those who think of brokers in terms of securities, the team did not examine the securities law environment in any depth either.

c. Credit Rating Agencies

There are two organizations that currently aspire to be credit rating agencies, but they have not arrived. The Yugoslav Chamber of Commerce has a Financial Standing and Credit Rating Office, but, to the extent it is functioning, has little more than information on whether a company has paid its mandatory dues and is in good standing with the Chamber. ZOP, the National Payment Bureau, plans to provide financial standing reports on the based on filings of financial statements by registered companies. There is no capacity, however, to verify the accuracy of the statements. Additionally, the information will have little value unless based on International Accounting Standards or rules that will provide a means of comparing the information with that produced in other countries.

While both of these plans are well intentioned and could add value to credit rating services, the efforts will not have a significant impact until there is a public registry of credit information available for viewing by those with a legal right to obtain such information.[18] Development of a collateral registry and standardized accounting methods will be important steps in creating credit information and a culture of credit information. Over the long term, the existence of any such agency will depend on demand of the private sector financial and credit system for inexpensive, reliable credit information as an integrated part of the credit application process. Such demand does not currently exist due to the breakdown of the commercial banking system and its reliance on personal relations and extensive guarantees.

d. Enforcement Agents

Enforcement is a glaring hole in the commercial law system. There is currently no effective mechanism for enforcement against movable property, only against bank accounts through ZOP, the national payment bureau. Repossession, according to one deputy minister, simply does not exist. Self-help, in the American sense, is unknown.

For the commercial legal system to function effectively, it must be possible for creditors to enforce their rights against recalcitrant debtors, including attachment and seizure of property. Long-term assistance will be needed to correct the legal framework and construct the supporting institutions necessary to turn a judicial decision into an enforceable right.

e. Feasibility, Turn-around, and Management Consultants

Several schools in Serbia are teaching management principles, but the population of experienced management consultants is quite limited. With the upcoming wave of privatizations, the demand for such services will very quickly outstrip the supply. Assistance is needed in the short-term to begin training such professionals and partnering them with experienced foreign advisors to handle the first waves of privatization. Otherwise, privatizations are likely to be little more than an interim step on the way to bankruptcy for most state-owned enterprises.

[18] *It is doubtful whether current privacy laws, or the European culture of privacy of information that influences Serbia, will permit a truly public registry. They may, however, permit disclosure of information based on agreement of the party to be investigated, which could become a prerequisite to receiving a loan.*

f. Filing Services

Filing services are a niche service industry for filing of documents at registries, including company, collateral and property registries. Individuals and companies with established expertise in the mechanics of filing can reduce the cost incurred by attorneys in having to spend their own, more expensive time performing such ministerial acts.

Before such services appear, however, the conditions must be right. There must be a high enough demand for "filers" to be able to support themselves through providing services on a full time basis, and the cost structure must make it more beneficial for an attorney to delegate the work to someone else.

These conditions do not yet exist in Serbia. Perhaps filing services will appear as the collateral lending industry grows (on both movables and immovables). In any event, this is a low priority at this time, and should ultimately be left to the private sector based on market demand, not on donor assistance.

g. *Specialized Publishers*

Yugoslavia has an excellent foundation in legal publications. In addition to an up-to-date official gazette, there are two magazines that republish all laws, many with commentary, and are available on a subscription basis. The bar associations publish legal articles and even the Serbian Judges Association publishes significant decisions from the upper level courts. Legal information is relatively easy to obtain. Moreover, most recent laws are available *in English* on a subscription bases from Yugoslav Survey, and independent publisher of legal and economic information.

Interestingly, law has not yet moved to the internet as rapidly as it has in many other countries.[19] The Official Gazette sells copies of the law in hard copies to subscribers and other purchasers and apparently is reluctant to change this practice because of the revenues produced. This has given rise to two other publications that purchase the laws in document form (the Gazette will not sell CDs, diskettes or other electronic formats), scan them, then republish them for subscribers with commentary or scholarly articles on legal issues. It is hard to imagine that the law will not soon be converted to electronic publication over the internet as well as in hard copy on the basis of public interest in providing the law to the public as cheaply, quickly, and effectively as possible. This will, of course, have an impact on the republishing market, causing the existing magazines to re-engineer themselves for survival.

Standardized forms do not yet constitute a significant number of legal documents. Unlike many countries in which standard commercial transactions have been reduced to highly standardized commercial forms and contracts, Serbia has only a few legal documents that must be or are preferred to be in a pre-printed format. On the other hand, the publishing industry is quite good and can produce whatever forms may be developed.

19 *For Bulgaria and Croatia, published laws are available on the internet at no charge from the moment of publication.*

It would be useful to provide assistance to practicing lawyers and law faculty to design standardized forms both as an improvement in efficiency and as a training tool for law students, lawyers, business people, judges, and even bankers.

h. Universities, Foundations and Think Tanks

Serbia has a substantial supply of educational institutions. There are currently four law schools operating in the country (not including the law school in Pristina, Montenegro) - at Belgrade, Nis, Novi Sad and Kragujevac. The quality of education has been compromised somewhat by political manipulations of the faculty under the prior regime, but the damage has been contained. Even so, these schools suffer to some extent from outmoded teaching techniques in which some of the professors do little more than read notes to the classroom with little or no discussion. Many of the best students study independently and skip these classes to do the reading on their own. Others are more progressive, using new techniques as well as actively participating in legal changes in Serbian society. Significant change is unlikely in the near term, because the supply of lawyers is more than adequate and there is little demand for change other than complaints of the students.

There are also several faculties of economics around the country. Many law professors teach at these institutes in addition to or instead of at the law faculty.

4. Trade and Special Interest Groups

a. Banks and Banking Associations

The Serbian and Yugoslav banking systems are in complete disarray. Of the 60-70 existing national and federal banks, it is estimated that no more than 10 are financially solvent, and even those are not particularly strong. The banks were badly damaged by misuse of the system under the Milosevic regime through politically based loans that could not be enforced. The system also suffered from an inability to make the transition to market-based lending after decades of socialist banking practices, which were not sufficiently grounded in commercial requirements based on cash flow, asset quality, and other risk reduction factors. Pyramid schemes in the early 1990s damaged consumer confidence, so that today much of the economy is based on cash transactions and hoarded savings, rather than productive investment and higher liquidity afforded by a system of healthy financial institutions.

The government has begun, with donor (including USAID) assistance, a program to liquidate insolvent institutions. While this is unlikely to restore consumer confidence, there is a slow inflow of foreign banking investment. The MicroFinance Bank, a European-funded and German-managed institution, for example, is offering traditional banking services, including loans up to $25,000 to qualified individuals. Societe Generale of France has opened an office to provide financial services to larger companies, and Raiffesenbank is scheduled to open in September. The government is seeking foreign investors to help restore some of the domestic banks, but the recovery process may be slow and deliberate.

As a result of this crisis, there is currently little credit available of any sort. Many importers and exporters rely on either countertrade arrangements or consignment agreements built up over several years through growing trust with foreign suppliers. Letters of credit and other trade finance mechanisms are often used. On the consumer side, there is also little credit. The local Visa card operation currently works only on a debit card basis, with cards being used to withdraw from existing deposits. Large items, such as automobiles, must generally be purchased for cash, possibly through three payments over a six-month period, otherwise through pre-payment "lay-away" plans.

Although land can be used as collateral for mortgages, banks have generally discontinued the practice because such lending, at least until recently, was a commercial farce. Many loans were made for political reasons and no amount of collateral could secure a loan to someone who would be protected upon non-payment. Moreover, even in commercial loans, the debtor-protection biases of the courts and contract law made it difficult if not impossible to enforce a loan effectively. One bank currently takes collateral on movables and immovables, but only for psychological pressure: the bank considers it unlikely that the pledges will actually have much value in an enforcement proceeding. For some customers, banks will provide a loan against cash deposits, with security of 30% or more of the value of the loan.

Despite the rather dismal banking climate, there is a relatively good bankers association. The Yugoslav Association of Banks (YAB) was once a reasonable strong organization representing interests of the numerous banks of Yugoslavia and Serbia, but was undermined by the misuse of the banking system under Milosevic. The organization is currently seeking to rebuild its credibility and services, and is thus very open to working as a counterpart in banking reforms. YAB leadership has also expressed strong interest in supporting the development of a collateral lending and registry system.

Liquidation of insolvent banks plus foreign investment in new and existing banks will be needed to restore confidence in the system and convince the general population to move their money from their socks to a bank account.

b. Business Associations

For the past ten years, most associations were political in nature, representing the rise of opposition parties. In this highly political climate and deeply dysfunctional economy, there was no significant development of business associations. Under the controlled economy, they were generally not needed, and have not yet made the turn to a market economy.

It is reasonable to expect a large growth in associations over the next few years. The well-educated professional class in the various economic sectors of society is familiar with these organizations and their roles elsewhere and can be expected to create appropriate domestic models. Assistance will be needed, however, to help organize the commercial associations an and NGOs, many of which will have little if any experience in providing services to members based on membership demand.

c. Chambers of Commerce

The Yugoslav Chamber of Commerce and industry describes itself as "an autonomous, non-governmental, business and interest association" for the Federal Republic of Yugoslavia. From a Western perspective, it would be better described as a semi-autonomous, quasi-governmental association for the simple reason that it is funded by fees extracted by law from registered businesses who are mandatory members. In essence, the Chamber exists only through government funding, even though it is not directly influenced or governed by government officials. Although it is seeking to provide services, the service model is based on supply-side strategy, not necessarily the demands of the members it is supposed to represent.

Even so, it should be noted that the Yugoslav Chamber has a well-organized, well-conceived management and infrastructure plan to provide a number of services for the various departments it has constructed on paper. The Chamber recently received support from the Konrad Adenauer Foundation to establish European Business Information Centers, an international, state-sponsored network of decentralized business information providers who will work from the numerous Chamber offices throughout the country. This could be a very useful source of information to small and medium producers and consumers, and to foreign investors. It will also produce a great deal of statistical data about local business, which could serve to enlighten policy discussions and initiatives.

The ambitious mission of the Chamber is currently more a document than a program. Numerous contacts for specific services are listed in their materials, but attempts to phone the desk officers resulted in very few contacts. The Chamber is an excellent source of preliminary contact information for foreign investors, including ministries and other government agencies, and it produces useful statistics and profiles regarding the various economic sectors. Still, lessons learned elsewhere suggest that such an all-encompassing chamber is unlikely to realize its dreams as a clearinghouse for all sectors of commercial society. Generally, competing interests prefer to have their own organizations, which might eventually form into a federation for certain purposes. For example, many transition and developing countries start with a similar chamber, and soon have separate associations of producers, exporters, service providers, merchants, and others who may or may not wish to cede authority to a single body to represent even common interests.

The Chamber may also be hampered in its goals by its incentive structure. Although currently well meaning in its ambitious plans, the fact is that funding is mandatory and the Chamber leadership does not have to answer to its membership. Structurally, there is no accountability based on demand. In many other countries, such a system has led to a shell Chamber abandoned by its mandatory members, many of whom will pay to belong to competing voluntary associations that more directly answer them. The Chamber has very good human and infrastructural resources, and could provide various valuable services. Over the next few years, it will be useful for the Chamber to reconsider its mission and incentive structure to adjust to a demand driven civil society.

Bilateral Chambers of Commerce are expected to appear shortly. The American Chamber of Commerce (AmCham) has already begun to organize locally, and other significant trading and

investment partners can be expected to follow suit, or, if already here, to increase the scope of their activities under the liberalized political and economic regime. These chambers are generally more like voluntary business associations, providing a crucial source of information regarding foreign practices, partnering opportunities, and feedback to policy makers issues affecting the commercial community.

d. Foreign Investors Associations

At the time of this writing, Serbia did not yet have a foreign investors associations or council. Such bodies in other countries are an important lobbying group for legal and policy reforms needed to improve the investment environment. It is expected that at least one such organization will arise on its own without donor assistance, because the potential members tend to be significant investors who can afford membership and understand the goals and functions of the such an organization.

IV. SPECIFIC LEGAL REFORMS

A. Bankruptcy

1. Background Comments

Bankruptcy law and practice are at a curious crossroads in Serbia, with one system ending, and the other not quite underway. The collapse of the former centrally-planned economic system has left numerous companies insolvent or failing, from systemic problems leading to commercial failure. On the other hand, new investment based on commercial lending and free-market practices has not fully begun in earnest, so that there are not yet any "normal" bankruptcies taking place. The bankruptcy law, fashioned in part on capitalist principles, is expected to handle both systems.

Bankruptcy, fundamentally, is a system for dealing with *commercial* debt, and especially with competing commercial claims to encumbered property of the debtor. Historically, little lending in the former Yugoslavia was been based on normal commercial practices and safeguards. Moreover, the last ten years have seen increased misuse of the banking and finance sector to provide loans based on influence, political patronage, ideology, and other non-commercial bases. In addition, existing law has not permitted priority claims on movable property within the debtor's possession, so that priority disputes relate to the overall bankrupt estate on a cash value basis (that is, only claims to money).

Much of the debt now owed by insolvent companies was extended based on such non-commercial practices. As a consequence, there is something of a mismatch in using the commercial mechanism of bankruptcy to clean up a political mess. Courts are very reluctant to assist with this process, fearing the socio-economic and even personal impact of shutting down companies and eliminating laws. Many feel that the situation needs political solutions as much as legal ones.

One solution moving forward under the privatization program is to place bankruptcy claims related to privatized companies within a different system. Some legal professionals have expressed concerns about the existence of parallel systems with potentially different rules operating simultaneously. We believe that the concerns are overstated. First, privatized companies form a special breed. They were created by the state, financed under non-commercial practices, and are now being sold to private investors. The "baggage" they carry is substantially different than the circumstances in new and recent investments in private-sector enterprises. Second, this type of company will disappear. If the privatization plan works according to schedule, they will all be sold or liquidated within three years. In other words, the old game is ending and a new one is starting – although there are similarities, there are new rules, new players and new expectations. Third, any new bankruptcies of companies under the new legal regime are likely to be several years off because it usually takes a new or newly capitalized business two or three years to fail. Finally, a separate system for privatized companies might be more effective at addressing the political and social concerns that bankruptcy court judges do not feel qualified to confront.

Clearly, a modern bankruptcy law is needed as the country moves into a new era of commercial lending. For the short-term, the law is needed to define the rules of priorities among creditors as a basis for commercial lending practices for *future* bankruptcies that are likely to begin in a few years, especially as regards security interests in movable property. It is therefore essential that the two laws be considered together to ensure compatibility. With plans to have a new draft Bankruptcy Law ready by mid-September, it is possible that the new law will need to be amended thereafter to be consistent with the eventual collateral law. It might be prudent to take a less expedited approach to the bankruptcy law to avoid such conflicts, and to obtain sufficient feedback from the financial and lending community to ensure local ownership by those most affected.

2. Framework Law

The current Bankruptcy Law is set forth in *The Act on Compulsory Composition with Creditors, Bankruptcy and Liquidation,*[20] a federal law of FRY. The basic structure of the law is sound and can serve as the basis for revision: there is no need to replace it with an entirely new statute. However, significant changes are needed in several areas.

Scope of the Act. The Law applies by its terms only to entities, not to individuals. Article 4 defines "debtor" as "an enterprise, cooperative, bank and other financial organization, property and personal insurance organization and other entities designated by law" (emphasis added). Individual debtors are not included. Bankruptcy, however, should embody two distinct policies: (1) fair treatment of creditors of an insolvent debtor, and (2) relief of debtors from the destructive effects of crushing debt. In both cases, the law should cover individual debtors as well.

The lack of bankruptcy protection could discourage individual entrepreneurs from entering very beneficial business activity. Such investment is essential to broad-based economic growth and needs to be covered. To the extent that individual bankruptcy is covered by other laws, the more efficient approach is to include both individuals and enterprises under one code.

Trigger Mechanisms. The Law does not clearly state when a debtor is subject to bankruptcy proceedings. In practice, proceedings may be instituted by the National Payment Bureau if a debtor fails to meet obligations within 60 days, but this not stated in the Law. Likewise, practice permits creditors to commence proceedings if not paid within 60 days, but even this is not clear. Several practitioners interpreted this differently, with some believing that the trigger was defined as a failure to pay a *judgment* within 60 days. In either case, the law itself is silent. The Law should permit commencement of proceedings when a debtor becomes insolvent, and then clearly define what is meant by insolvency.

In practice, the National Payment Bureau has been known to enforce bankruptcy requirements aggressively but not transparently. During the past ten years this enforcement has been severely tainted by political manipulation. That is, numerous bankrupt or delinquent companies were not been placed into bankruptcy if they were connected to the Milosevic regime, while others were subject to bankruptcy procedures by the Bureau without proper cause. The Law needs to provide

[20] *Published in "Službeni list SFRJ" Nos 84/89 and "Službeni list SRJ" Nunbers 37/93 and 28/96.*

clear requirements for when and how the State may commence proceedings, with evidentiary requirements to protect they system from such abuse in the future.

Under international best practices, the debtor also has an independent obligation to commence bankruptcy proceedings based on various triggers, such as cash flow and balance sheet tests. The Yugoslav law does not obligate the debtor or provide sanctions for failure to seek bankruptcy protection in a timely manner, indicating that the existing law may not have been based on a clear understanding of the rehabilitative capacity of bankruptcy procedures. By essentially limiting the trigger mechanism to the government enforcement agents, bankruptcy practice becomes an instrument of the state to monitor insolvency rather than an instrument of creditors and debtors to rehabilitate failing companies before it is too late. It may be necessary to provide for public education as well as revision of the law in order to increase understanding of the uses of bankruptcy proceedings other than simply carving up the assets of a defunct company.

Restructuring. The Law provides only one possibility for restructuring a business entity: composition of debts. This is much too narrow. There may be other ways (of which composition may be only a part) acceptable to the bulk of the entity's creditors to deal with the financial problems of an entity. These include refinancing arrangements, debt restructuring, new investment, temporary postponement of claims, surrender of assets to creditors, "buy out" of some creditors only, compromises of claims, issue of shares to creditors or any combination of measures that the insolvent entity wishes to put before its creditors.

A system that permits a much broader range of proposals must necessarily be more complex than one providing only for composition of claims since a proposal may affect different groups of creditors in different ways. It would require a mechanism for classifying creditors so that voting is by class according to the interests affected. The benefits of a more flexible system outweigh the difficulties associated with a more complex system.

Secured Creditors. A central feature of a modern bankruptcy and insolvency system is the balancing of the rights of secured creditors with those of unsecured creditors. This will become very important in the Federal Republic of Yugoslavia when secured financing law is modernized so as to encourage financial institutions to provide financial accommodations for new businesses and the expansion of existing businesses. Bankruptcy law should be drafted so as to anticipate and accommodate this change, and in concert with the drafting of the Collateral Law.

The Law already provides a basis for the special protection of secured creditors through a generally uniform approach to their rights. Secured creditors "who obtained a right to separate satisfaction of their claims by enforcement and security at least 60 days in advance" of opening of proceedings for compulsory composition or opening of bankruptcy proceedings are not affected by the proceedings. See Articles 30, 41, 99 and 117. While it is not clear what constitutes "a right to separate satisfaction by enforcement and security" it is presumed that this includes an enforceable security interest in a debtor's property. See also Article 19(5).

However, a secured creditor who cannot bring its claim within this test may not assert its rights as a secured creditor. As a result the creditor's claim must be treated as an unsecured claim if the

composition is approved. Where bankruptcy is involved, collateral under a security agreement becomes unencumbered property of the estate. This is not appropriate.

A positive feature of the Law is that it recognizes the independent right of secured parties to enforce their security interest even though the debtor becomes a bankrupt or has sought composition of debtors. As a general rule, insolvency and bankruptcy proceedings should not negatively affect the rights of secured creditors unless those creditors acquire an unfair advantage through their security agreements.

The 60-day rule applicable to secured creditors is presumably designed to avoid giving an advantage to creditors who are able to elevate their claims to a secured status just prior to invocation of composition or bankruptcy proceedings. This is an understandable policy choice. However, implementation of the policy through the 60-day rule is problematic.

It is difficult to understand why a secured creditor who gives new credit during the 60-day period should be penalized. This is particularly so where the new credit was used to acquire new assets in which the security interest was taken (purchase-money security interest). To allow the secured creditor to enforce its security interest any time before or after invocation of insolvency or bankruptcy proceedings does not in any way prejudice unsecured creditors. There is no net loss in the value of the estate as a result of the creation and enforcement of the security interest.

The problem with the 60-day rule in its current form is that it introduces a major element of uncertainty in secured financing. A financing organization will not be willing to grant secured credit to a debtor if there is any reasonable chance that bankruptcy or composition proceedings will be started in the near future. The lack of clear rules for determining when these proceedings can be invoked adds to this uncertainty.

In a developing economy like that of the Federal Republic of Yugoslavia, there is a great need for development financing. Many of the new business organizations that will be the source of much of the business activity will be high-risk borrowers. In this context, it is important to ensure that lenders who are the sources of new secured financing for the acquisition of business assets are not frightened away from the market by fear that they will lose their secured status should their borrowers become bankrupt or make a composition proposal within a short period of time after getting loans.

Any system of modern Collateral Law adopted by the Federal Republic of Yugoslavia is very likely to provide for a centralized, electronic registry for security interests in movable property. One of the roles of such a registry is to warn potential creditors, including unsecured creditors, that assets of a debtor are encumbered and not available to satisfy unsecured debts. It follows from this that an unregistered security interest should be unenforceable against unsecured creditors and an administrator in bankruptcy proceedings. A revised Bankruptcy Law should address the issue of registration and the distinction between registered and unregistered interests.

In one respect the Act is too favorable to secured creditors. The administrator should be able to force a secured creditor who is protected by the 60-day rule to sell the collateral or provide a reliable valuation of it and turn over to the administrator any surplus over and above what is

necessary to discharge the obligation owing to the secure party. Alternatively, the administrator should have the right to redeem the collateral and pay out the secured party. Article 118 provides that a surplus must be given to the administrator, but there is no mechanism to ensure that the secured party has properly valued the collateral.

3. Implementing and Supporting Institutions

Bankruptcy practice is also weak. First, the courts need assistance in understanding the complex issues involved in bankruptcy proceedings. There is no meaningful experience in bankruptcy practice. In fact, no bankruptcy cases have been fully prosecuted through the courts. To the extent that they may eventually be prosecuted under existing law, the ability of courts, liquidators and trustees to gather assets for auction or sale is suspect, at best. There is simply not an effective mechanism for attachment and execution of property, other than bank accounts attached through the payment bureau.

Existing law does not adequately provide for seizure or attachment of assets either by secured creditors or prior to judicial execution. Repossession does not exist. Self-help is not permitted, which is logical in a system that does not recognize priority rights under non-possessory pledges. Current practice for execution on assets provides for prior public notice of an auction, without arresting the assets, at which point assets frequently "disappear", leaving the subject business as an empty shell.

It is not surprising that support services for bankruptcy procedure are lacking. Bailiffs, trustees, management turn-around specialists, evaluators, appraisers, and even qualified auctioneers do not exist in sufficient supply to support the anticipated growth in bankruptcy practice.

One final area of concern is the attitude of the Commercial Courts towards bankruptcy practice. The Courts simply balk at the formal, involuntary liquidation of large firms employing significant numbers of workers.

To give just one example, the Zastava car factory in Kragujevac, which used to manufacture Yugo automobiles, has been wholly or largely idle and in a state of de facto bankruptcy for over a year. However, the Kragujevac Commercial Court has been reluctant to apply the law, since this would result in hundreds of workers being thrown out of employment. Instead, the Court has held the case in procedural limbo, hoping that some higher authority will step in with a solution.

Broadly speaking, the courts seem to consider these sorts of cases as being outside their jurisdiction, much as an Anglo-American court might view a ‘political question’. And, indeed, any overhaul of the bankruptcy law will have to at least keep one eye on the potential social and political consequences of liquidation, however economically efficient and otherwise desirable it may be. Close cooperation with relevant NGOs and/or government ‘safety net’ agencies may be called for here.

The current status of the bankruptcy system suggests that comprehensive assistance is needed to create and establish a regime that supports economic growth through commercial lending. The

law needs to be carefully rewritten in accordance with international best practices, particularly in regard to triggers, debtor obligations, and priorities. Court personnel will need to be trained along with all other support service providers. In terms of sequencing, it is possible to commence assistance to liquidators, management turn-around specialists, and execution agents (bailiffs, for example) prior to revision of the Law, as their duties and roles will not be diminished under a new regime. Indeed, liquidation should probably be a high priority program separate from (but connected with) other aspects of the law due to the immediate need for liquidation of numerous insolvent state-owned companies. On the whole, bankruptcy reform should be seen as a multi-track, long-term program of assistance.

4. Market for Reform

The market for bankruptcy reform is being driven by the insolvency crisis in state-owned companies. In many transition countries, the demand for reform comes primarily from the outside – international financing institutions. The Serbian government, however, is pushing hard to reform

B. Collateral

1. Background Comments

The credit that is required for the growth of a modern market economy must come from the private sector. Collateral Law provides the legal basis for extension of credit, which, when properly constructed, permits creditor to reduce their risks, lower costs, and increase credit availability to borrowers of all sizes. It is not generally one law, but rather a collection of private and public laws which include contract, property, commercial, company assets, judicial process, the code of civil procedure, bankruptcy, foreclosure, judicial sale, land registration, and movable property registration, among others. Although Collateral Law may be codified into a single act, including laws on registration, this is not required. Codification is useful (and courts are generally more comfortable with such an organized framework), but it is most important that the related laws are complementary and consistent with each other.

Countries that do not have modern systems of law to facilitate credit granting will find that their producers are not competitive with producers in other countries that have such laws because they either cannot get credit to expand, improve productivity, or enable them to trade more effectively or because the credit that is available to them is much more expensive. Under existing law, Serbia and the FRY cannot be competitive.

This situation can be rectified, as is being done in other former Yugoslav republics and other transition economies, through adoption and implementation of Collateral Law and practices designed to facilitate “asset-based” financing and, thereby, encourage a much higher level of secured financing. Asset-based financing reduces the risk of loss on a loan due to default by allowing the creditor to “secure” the indebtedness in whole or in part through a right of pledge on the assets of the borrower. This provides an alternative source of repayment should the debtor fail to meet contractual obligations, as well as a strong disincentive for non-payment by the

debtor, because assets subject to a pledge can be seized and sold and the proceeds of sale can be applied to the undischarged portion of the obligation.

2. Legal Framework

Collateral Law in the FRY and Serbia is not adequately covered by existing legislation. Although Chapter XXVIII of the *Law of Contracts and Torts*[21] purports to cover secured transactions, it is wholly inadequate. Other chapters and separate laws cover various aspects of secured financing, but the coverage is not sufficient to support economic growth through the expansion of credit. Moreover, there is no legal framework for registration of security interests to protect priority claims of creditors or provide notice to third parties of pledges. In short, the existing framework is similar to the types of secured lending mechanisms in use approximately one hundred years ago, before the development of modern asset-based lending and finance.

On the other hand, the legislative framework of the Law of Contracts and Torts does provide a convenient vehicle for establishing the new law. Rather than creating a separate code or body of law to cover secured financing – an approach not altogether popular among practitioners – it is possible to revise Chapter XXVIII, replacing it with secured financing law containing the most advanced features found in international best practices.

Aside from the general inadequacy of the current law, there are a number of specific gaps that need to be addressed through legal reform. These include:

- There is no general system under which a pledge can be taken on property that is left with the pledgor. Release of a property to a debtor or third party eliminates any priority claims by the creditor in the property. This means that modern secured financing is practically impossible except where property such as securities are involved.

- There is no provision for flexible security devices such as pledges that attach to after-acquired property. Consequently, there is no possibility of financing inventory of manufacturers or small businesses.

- There is no basis for broadly based security interests that create in one contract a non-possessory security interest in a wide range of movable property including negotiable property such as securities and documents of title (warehouse warrants) and negotiable instruments.

- While assignments of accounts are recognized, priority is based on first to notify the account debtor (see Article 439). This approach cannot support modern bulk accounts financing since it is not practical to notify every account debtor. Priority should be determined on the basis of registration in a public registry.

[21] *Zakon o obligacionim odnosima*, published in the Official Gazette of the SFR od Yugoslavia (*Službeni list SFRJ*) nr. 29/1978; Amendments in nrs.: 39/1985, 45/1989, and 57/1989; final amendments in the Official Gazette of the FR of Yugoslavia (*Službeni list SRJ*) nr. 31/1993.

- There is no recognition that a title retention sales contract is a financing device and should be regulated as such. There is provision for registration of conditional sales contract, but no registry (see Article 540(3)).

- There is no recognition that many long-term leases are, in function, security devices that should be regulated as such (including registration). There is need for rules that define the relationships between parties in two-party (lessor-lessee) and three party (supplier-lessor-lessee) relationships.

In short, the tools needed for increasing the expansion of credit to small, medium and large businesses in all sectors do not yet exist. Although at least one secured credit program is underway for small and medium enterprises, it requires 300% collateral for the loan: this is not a long-term solution in an increasingly competitive global and regional economy. A new law is urgently needed.

3. Implementing Institutions

Collateral Law has two institutions that are required if the system is to function effectively: registries and courts. With only limited recognition of the concept of non-possessory pledges, it is not surprising that Serbia and the FRY have no mechanism for registration of security interests for public notice. Certain contracts can be registered with the court, but this practice merely establishes rights between the parties and does not provide notice to third parties that there is an interest in the collateral secured by the contract. At present, the only effective system of notice is through possession of collateral by the creditor, not the debtor.

A pledge registry is essential for a modern Collateral Law to achieve its potential. Registries establish the priority of claims, protect creditors and third parties from fraud by debtors by providing public notice of interests in the property. This reduces risk of loss to creditors, and thus lowers the cost of credit. It also replaces possession by the creditor, because public notice is given through the registration of interests in pledged property, not by possession of that property.

Although there is no current registry system, there are several potential hosts for such a registry. In some countries, the Commercial Courts manage the Collateral Registry, in keeping with the tradition of placing registries within courts. This is not necessary, and, in Serbia, is not desirable. The courts are insufficiently funded for their current duties, and this additional responsibility would create additional strain. Moreover, there is no need to place such a registry under court supervision: registration is a ministerial task only, with no review of underlying documents or claims. Indeed, some of the current registration duties (such as review of company registrations) should be revised to reduce judicial involvement.

Some countries permit registries to be run by the private sector. Although this is technically feasible, it is not advisable for Serbia. Yugoslav legal culture favors public-sector operation of entities that provide law-related services. While it is possible that registry services could eventually be privatized, now is not the time.

The National Payment Bureau (ZOP) has expressed interest in hosting the registry. As a decentralized institution with branch offices throughout the country, linked computer data gathering capacity, and experience in collecting financial information and providing statistics on that data, it is certainly a qualified institution and should be given serious consideration for this role. On the other hand, it is not clear how the financial community and the general public view this rather unpopular institution, and whether distrust or dislike of ZOP would inhibit use of secured lending. Further research is needed before a decision is made.

Whatever the decision on who will host the registry, enforcement of the underlying law and contracts based on that law is essential, and this is done primarily through the Commercial Courts. One of the principle obstacles to an effective system is a lack of confidence in the courts to enforce collateral contracts. For the past ten years, Serbia has been known as a debtor's paradise, where courts will generally not permit enforcement, but instead provide more time or excuses for the debtor at the creditor's expense. (Indeed, the Law on Obligations permits the courts to rewrite the terms of the agreement in certain instances if they find that penalties for non-payment or non-performance are too extreme. There is no guidance for this measuring when such intervention is appropriate.) This bias appears to flow mostly from misunderstanding the impact of this approach -- judges do not realize that they are destroying the credit system with this approach, but feedback from initial presentations and discussions on this problem suggest that there is openness to change.

Some changes are already underway in this regard. A new Law on Execution Procedure was enacted in 2000, regulating the procedure for execution of final judgments in civil and commercial matters and for the securing of payments. Execution is based upon an “executory document” which establishes that the obligation exists. An executory document is a final decision of a court, any kind of arbitration or administrative body, and a court settlement between disputing parties. If the creditor is a legal person or a trader, an it suffices to submit to the court a “veritable document,” which the law defines to include an invoice, bill of exchange and cheque with a protest, a public document (deed), an excerpt from certified business books, or a document executed in a legally prescribed form.

For effecting monetary payments the following action can be ordered by court: sale of movables, sale of real property, transfer of funds from one bank account to another, assignment of obligation to deliver goods, sale of other rights, transfer money from one ZOP account to another. The same can be done for securing payment, but instead of sale, a pledge or mortgage can be established by court order and appropriate action based on it.

A creditor can establish a court pledge or mortgage on movables and real property as a means of securing a debt (“court established collateral”). Any court decision is published in the official gazette. Execution on movables and real property is effected by the sale of such things.

Overall the new law provides a solid legal basis for execution. Also the new law shortens procedural periods, and therefore execution should be effected faster. Existing law and practice do not permit the creditor to retake and sell the collateral, which is a weakness, but the changes in general are moving in the right direction. However, to be truly effective the courts must understand the new law and the economic consequences of their failure to fully enforce it.

4. Supporting Institutions

The foremost Supporting Institution for Collateral Law consists of the enforcement authorities that the courts rely upon to attach pledged assets and sell or turn them over to creditors. Assuming that the courts enforce the pledge contract, they must then rely upon bailiffs and police to seize assets for satisfaction of judgments. Currently, the courts and the police are not operating effectively. In some cases, the police have simply refused to assist in obtaining property from a recalcitrant debtor. Without police intervention, the bailiffs or other enforcement agents of the courts are powerless to fulfil their functions.

During the Milosevic regime, police were sometimes encouraged not to perform their duties through orders from the political oligarchy. In addition, there was simply a general lack of willingness to participate in this function, causing the legal system to fail. One result was the use of illegal enforcement mechanisms in which some creditors hired gangsters to force payment or repossession. The fees for such services were reported to be 15-20% of the price of the property or debt collected.

Clearly, a comprehensive project will be needed to ensure a viable collateral system. This should include training for police and bailiffs. There is no established practice of repossession, and much assistance is needed to establish appropriate mechanisms. The training should also include education on the need for secured credit, and the impact on the economy and individuals if these agents do not enforce the law.

Banks and banking associations are also essential Supporting Institutions. As previously noted in this report, the banks are currently very weak, with most existing banks close to bankruptcy, if not in fact fully insolvent. Those that may survive do not have any meaningful experience in asset-based lending involving non-possessory movable property. Training will be needed.

On the other hand, the Yugoslav Bankers Association has expressed strong interest in furthering the development of a modern banking system. The Association was once a well respected and reasonable well financed institution acting on behalf of the interests of the Yugoslav banks. Although weakened during the past 10 years, it still has a role to play within the banking and financial community. During revisions of this report, the Association has supported Collateral Law initiatives on two occasions – once by inviting Booz-Allen technical specialists to make presentations on Collateral Law at a conference of the Commercial Lawyers Association, and once by co-sponsoring a workshop on Collateral Law supported by this USAID project. They can be expected to continue serving as a proponent of reform.

Lawyers are another Supporting Institution. Currently, only those who have practiced law outside of Yugoslavia in countries with modern Collateral Law and registry systems have any experience in this area. Substantial training will be needed. Such training should be done through the various local and national bar associations and the Association of Commercial Lawyers.

5. Market for Reform

Practical demand for secured financing is high. At the consumer level, there was unanimous support among those interviewed for the concept of a system that combined possession of property by the debtor with long-term payment at improved interest rates.

Among some practitioners, government officials and academics, however, there was some resistance. This resistance tended to be based on lack of understanding and reluctance to adopt changes perceived as "radical" in a period of social and economic instability. Because these were recurring themes, it is worth noting them here – they will need to be addressed on an ongoing basis.

One objection to adoption of the system was based on apprehension about replacing the practices currently in place. This objection was met, however, by pointing out that adoption of a modern collateral system does not mandate the elimination of other financing alternatives. It will still be possible to offer possessory lending, oversecured credit, and guaranteed loans. Collateral Law, however, will offer new options that are not currently available, thus expanding the portfolio of credit mechanisms. As a practical matter, it will eventually replace the existing tools for qualified debtors because banks offering secured loans will be able to beat out those banks that do not. Thus, this "radical" change is actually an expansion of opportunities.

Another objection was raised based on historical links with the German and Austrian legal systems. Several scholars noted that Germany does not have a modern collateral system, yet is certainly an advanced country economically. As a corollary, it was suggested that Yugoslavia does not need such a system, but can simply grow within German tradition. This objection was also successfully met on two points. First, the existing system under present law was similar to German law one hundred years ago, but even German law of today is changing to recognize the need for registration. Second, and more importantly, Germany is a fully developed country, and the existing system allows it to *maintain* that level, but not to *grow* rapidly. The FRY needs rapid, broad-based, and sustained growth, which cannot be attained by emulating a system for maintaining previously achieved growth.

It cannot be overstated that reform of the secured-lending regime will require broad-based support from all sectors. Although those who will directly benefit the most are the financial sector and private-sector consumers and investors, the government must also champion this cause for it to succeed. Due to poor understanding of Collateral Law and its importance to economic growth, this government support has been slow to develop. Fortunately, however, there has been important progress between the initial assessment and the revision of this report, with the Ministry of International Economic Relations recently adding Collateral Law to its reform agenda. Additional work will be needed to improve understanding among policy-makers and garner the support necessary for success.

C. Company

1. Framework Law

The Law on Enterprises (*Zakon o Preduzecima*) generally follows the European tradition of regulating individual entrepreneurs and several company forms. Those are traditionally divided

between associations of persons (such as various partnerships), and associations of capital (such as the limited liability company or the joint-stock company, which is for the most part the equivalent of the publicly traded company in the US).

In addition to those traditional forms, the Yugoslav law on Enterprises regulates also the so-called "social enterprises," which are a uniquely Yugoslav form for business organization. In theory, social enterprises are owned by the workers collectives. The restrictions on disposition of property and the problems with corporate management are so formidable, however, that this form of ownership is widely considered even by Yugoslav scholars as a kind of vacant ownership with unclear and restricted property rights.

The existence of social property creates various problems with respect to the transfer of property rights and privatization and is considered one of the principal obstacles to the establishment of clear property rules in Yugoslavia for investors seeking to purchase companies subject to social ownership claims. Even though the form is considered problematic, it has not yet been abolished in FRY due to social and political considerations, even though it has been abolished in the other former Yugoslav republics.

In addition, the Enterprise law regulates the so–called public enterprises (those, serving public needs or formed by public bodies), such as the Serbian Electric Utility for instance. While there is a separate law on those enterprises in Serbia, some of the provisions of the Federal Law on Enterprises are also applicable.

In general the law is based on licensing regime (i.e. prior to commencement of any activity, permission should be secured and a ruling received from the competent authorities, that the business meets the necessary labor, environmental, sanitary and other requirements), rather than on a compliance regime (whereby the business may start operating in most cases without the permission of the relevant authorities, but should be in compliance with the applicable regulations all the time). Respondents did not feel that this creates major problems, but it does explain the basis for burdensome registration requirements, which practitioners and company representatives universally wish to see changed. This is especially true with respect to small and medium entrepreneurial endeavors, where the bureaucratic burden can keep actors out of the market, or else redirect them into the informal economy.

The enterprise is required to follow the line of business, stated in the registration documents, and this provision applies for all types of companies (not for joint-stock companies only). Other business opportunities may be pursued only if incidental to the registered activity (Article 20). The officers of the enterprise are liable to third parties in case the enterprise is involved in non-registered business. This restriction - which limits the ability of a company to respond quickly to market changes in order to pursue opportunities not originally foreseen at incorporation - is based on the philosophical presupposition that registration represents a form of licensing. Although not strictly enforced in practice, the existence of this provision has created opportunities for harassment of small and medium businesses by the tax and other controlling authorities.

The company forms recognized in Yugoslavia are similar to those existing in continental Europe and in the German legal tradition in particular. The company form is usually indicated in the name of the enterprise and there is a compulsory requirement for an abbreviation in Serbian after the name, which indicates the form of association (that is d.o.o. for a limited liability company or k.d. for a limited partnership). The rules on names are similar to the European practice as well and do not represent problems in the process of enterprise formation. In addition to the name, every business entity has identification number.

The minimal capital requirements are relatively low ($10,000 or $20,000 equivalent for the two forms of joint-stock companies and $5,000 for the limited liability company), but given the proliferation of limited liability companies this amount seems elevated. In addition, the minimal capital investment for each of the partners in the company is fixed at $500, which may be too much for small businesses.

The assets of an enterprise may consist of money and non-monetary assets, including intangibles. The law has reasonable provisions requiring the maintenance of the initial registered capital and of specific reserve funds. Payments of dividends out of the capital are prohibited.

The powers of representation of the enterprise, including the powers of directors are also similar to the traditional European forms. The Yugoslav law recognizes and regulates the *procura* (Articles 45-46) as a specific representative power, which might be limited in scope and time in accordance to the decision of the corporate body that issued the authorization.

The law departs from general European practice in its provision for extensive representation of employees in the boards of social enterprises. Employees must form one third of the board (Article 83). Enterprises with over 50 employees must also form an employees' council, which has significant rights in the areas of profit distribution and management of certain assets. The current rights are inconsistent with the ownership rights in privately owned companies in developed market economies. These rights should be restricted in order to improve the value of the companies undergoing privatization, for the social ownership rights create both uncertainty and control issues that reduce the value of the privatized company to potential investors. This will inevitably result in some social tension. However, some respondents feel that most Serbs are pragmatic enough to see that the choice between losing social ownership claims and maintaining a job through rehabilitation of their employer is not a difficult choice. Unions are more likely to resist the change than the more pragmatic members.

The law provides reasonable guarantees for the access to information of the creditors and shareholders of the enterprise and guarantees, by providing such information publicly through the court registry.

The law also has clear and consistent conflict of interest rules, which prevents employees and board members from participating in competing activities or to using insider information for their own benefit. It is not yet clear whether these principles can be upheld in court.

Protection of minority shareholders in joint-stock companies is limited to their rights to convene a general meeting (Article 251), but not to influence the meeting. There are no cumulative voting

rights or other adequate representation mechanisms provided by law. While such rights may be included in the Articles of Association of any company, the current stage of awareness of the minority shareholders probably merits some more detailed regulations of those rights. Attention must be given to an improved regime for minority shareholder rights, especially in light of the increased participation of minority shareholders in the privatization process.

The Law on Enterprises has generally been adequate for existing needs. As Yugoslavia seeks to adapt to the market economy and to accelerate growth, some changes are needed. Revisions should include better protection of minority rights, simplified registration procedures, reduction of the minimal capital requirements for limited liability companies, possible increase of the capital requirements for joint-stock companies, especially in cases where capital is raised at public offerings, and better definition of the rights and obligations of the management bodies, including a more specific definition of the standard of care for directors. The clarification of the status of socially owned enterprises is an important issue in the transition period. It would be best if social ownership could be liquidated through the privatization process, rather than merely reduced as currently planned. Given the political need to continue this ownership form for a few more years, it is essential that it be defined better to protect the value of the companies being privatized under the social capital regime.

2. Implementing Institution

The Company Registry is responsible for the examining and approving or disapproving all initial registrations and amendments. The responsibilities are based on the licensing regime system, and thus are under the oversight of the Commercial Courts, where judges are expected to review the various applications before they can be approved. This system is the norm in the former Yugoslav republics, and has a long tradition in Europe. Tradition is changing in this area of business and is encouraged by the European Commission through its "Recommendation on Improving and Simplifying the Business Environment for Business Start-ups" and the OECD in its "General Principles of Company Law for Transition Economies." These recommendations and general principles extend beyond the intital filing of the company to the manner in which the activities of the company are monitored and activities are terminated. The focus is not on the location of the registration but the processes. The aim is to decrease the burdens on businesses in doing business.

The two approaches to registration of companies produce two very different results. Systems based on a licensing philosophy view the registration of a company as an explicit approval of the company and implicit guarantee by the state of the company's fitness for business. Consequently, registration requirements include various proofs of capacity, such as initial capital, statements from the police that the founders are not felons, and even health certificates for certain higher level officers and managers.

Other systems see registration as simple act of providing information for public notice in order to obtain the right to operate within a corporate form. The act of registration conveys no implicit or explicit statement regarding the capability, viability, or accountability of the incorporators, as these are issues that must be individually determined by anyone wishing to do business with the company. As a result, registration requirements are simpler, and no high-level approvals or

reviews are needed. Registration is performed by clerks who simply file the information provided and make it available to the public for review and investigation.

Yugoslavia's licensing approach has resulted in a relatively burdensome set of requirements for company registration. Judges complain that many filings are very poorly done by lawyers who do not properly understand the requirements, while lawyers complain that judges and clerks do not understand the law or misapply it. This problem could be addressed in part by better training of all involved, but these are only symptoms. The real problem is unnecessary complexity based on model that does not provide the protections it purports to in attempting to control company registration rather than facilitate it.

According to the Commercial Courts, less than 50% of all filings are done correctly; one president of a regional Court said that the figure was under 25%. Part of this problem may be perceived rather than real, due to defects in the courts' own filing and retrieval systems, staffing issues, and other problems. Much of it, however, is clearly the result of a burdensome and confusing registration regime.

The registration requirements for companies can and should be simplified in accordance with well-established and emerging international standards. The rules, once adopted, should be uniform throughout the courts and not subject to discretionary change, as corporate counsel currently complain about the existing system.

The registries themselves can also be improved. Filings are based on manual systems using pre-printed forms that must be obtained from printers. Although the forms are generally available, they cannot be processed by computer or substituted with computer generated forms by those registering, creating unnecessary manual requirements for users.

Given the manual system in place, the registries are actually fairly efficient, with filings normally taking no more than one month. While better than some of their neighbors, registration should take no more than one week under international standards. This can be achieved through basic process re-engineering and computerization of processes. As a long-term goal, the registries should adopt a system allowing on-line registration.

With privatization and revitalization of the economy, there should be a substantial increase in the number of registrations. It is important to institute changes now in order to avoid backlogs when the workload eventually increases.

D. Competition

Competition policy and procedure is governed by the 1996 Antimonopoly Law. This law is wholly inadequate and cannot be applied in any meaningful way. Consisting of only four pages of broad concepts set forth in 15 substantive articles, the law is over-broad and under-developed. For example, the definition and impact of "dominant position" do not distinguish between dominance gained through anti-competitive acts and dominance gained through excellence in competition.

There is no reason to fear that the law will be misapplied in the immediate future, however because the Competition Agency is currently no better than the law it is responsible for enforcing. Formerly an agency for price and market control, the change in name has not changed the function. The Agency, to the extent it operates at all, attempts to set "fair" prices instead of policing unfair practices. In short, the Competition Law and its institutional framework need to be overhauled from scratch.

Basic foundations exist for Supporting Institutions. There are a number of economic and statistical research organizations that could do or learn to do the analysis necessary for economic impact, market domination, and other studies required to prosecute or defend actions for non-competitive behavior. Once a proper system is in place, it is likely that market demand for such services will be met by these institutions, although some technical assistance may be required to introduce new concepts and practices.

The market for change is less certain. As noted in the Executive Summary, there is much support for protecting local industry against foreign competition and even for government intervention in pricing. This is not surprising given that fact that even the most advanced economies of Europe and North America still struggle with protectionist leanings, but it is more problematic for FRY and Serbia because there is not yet any significant countervailing support for openness. Impetus for change may come from the community of foreign investors, but even this is not certain – many foreign investors seek monopolistic concessions and incentives for their particular investment, not an open, competitive environment. Effective reform in this area will require both strong leadership and public education on the benefits of competition.

E. Contract

Commercial contracts are governed by the *Law of Contracts and Torts*[22] (the "Contract Law"), which is based on the Swiss Law of Obligations. As a general rule, the legal community, including judges and lawyers, and the business community are generally satisfied with the content and quality of the law. In fact, it is a point of pride, as well as the only significant body of economic legislation not currently slated for replacement or amendment.

The principle strength of the Contract Law is that it provides broad freedom as well as clear equality between contracting parties. Article 10 provides that contracting parties "shall be free, within the limits of compulsory legislation, public policy and good faith, to arrange their relations as they please." Indeed, the Law frequently provides the exception "unless the parties agree otherwise" to limit the mandatory nature of a number of specific provisions. Practitioners support this view.

Parties to the contract, according to Article 11, "shall be equal in terms of law." Most importantly, this includes government parties, who can contract on the same terms as natural and

[22] *Zakon o obligacionim odnosima*, published in the Official Gazette of the SFR od Yugoslavia (*Službeni list SFRJ*) nr. 29/1978; Amendments in nrs.: 39/1985, 45/1989, and 57/1989; final amendments in the Official Gazette of the FR of Yugoslavia (*Službeni list SRJ*) nr. 31/1993. The English title of "Law of Contracts and Torts" is the locally produced translation based on the contents of Article 1. A more literal translation of the official title is the Law of Obligation Relations.

legal persons, and are subject to suit in the same courts. There have been problems in the recent past in application of this principle of equality due to political manipulation of the legal process, but the statutory groundwork is proper. Each party is also subject to an appropriate and individualized standard of care (Art. 18), allowing courts to take into account the experience and professional status of the parties in determining the propriety of their actions in disputes.

The Law also follows international best practices in applying trade custom and usage (Art. 21), thus allowing flexibility to the courts and parties in arranging suitable relationships according to commercial need rather than legislation. It also permits parties to define liquidated damages (Arts. 270-71) and generally supports the freedom of contract proclaimed at the outset.

Numerous forms of contract are explicitly recognized, though not always sufficiently defined. There are provisions on loans (Chap. X), leases (Chap. 11), supply of services (XII), construction (Chap. XIII), and many others. The flexibility also allows for creation of contracts not foreseen in the law, so that framework is more than adequate for the current needs.

There are, however, two weaknesses in the contract law, one explicit and the other systemic. First, the law permits judges to rewrite the damage provisions of a contract if it is determined to be too burdensome for the debtor. For example, Art. 139 give the court the right to nullify contracts based on unequal bargaining power. This is fine if it refers to contracts of adhesion, but is not limited in that way, so that it can be interpreted very broadly to permit nullification just because the "little guy" did not get the benefit expected. Likewise, Art. 141 on Usury permits the courts to reduce damages to a "just amount" when it is deemed that one party took advantage of another being need or poor material situation. In some countries, these laws might be seen as limited in scope, but Serbian courts have a reputation for siding with the debtors, and such provisions only support the tendency toward inappropriate judicial interference with contracts.

The second problem is systemic. As noted, legal professionals are satisfied with the law, noting that it is generally sound with the exception of minor amendments needed (such as the pro-debtor bias clauses). When asked how they would introduce those changes, there is silence. There is no mechanism for those most attuned to the needs of the business community to provide input on changes to the law. In more developed legal systems, various associations (including business and legal associations) will have standing committees that capture information regarding needed legislative changes then introduce the needs to the legislative body or responsible government ministry. Serbia and FRY do not have such groups yet, nor do they have a formal mechanism for stakeholders to participate in or initiate legislative reforms. As long as commercial legal development is a supply side obligation divorced from the practitioners and stakeholders, it will not adequately support the developing commercial sector. This must be addressed and remedied.

F. Foreign Direct Investment

Trade and investment are being considered separately from commercial law under another USAID program and an assessment of the trade and investment regime was prepared by another contractor under separate funding. Even so, we inevitably encountered issues related to commercial law and thus are providing brief comments on certain issues.

Two issues in particular arose during the course of our assessment. The first relates to the need for a specific Foreign Investment Code or other law. Many development and investment specialists now advise that such laws are not necessary - most countries that enjoy substantial foreign investment have no specific code for foreign investors, but have an environment favoring investment for all investors. The Yugoslav Government has considered this position, however, and has chosen to create a special law for the express purpose of identifying the numerous laws affecting *foreign* investors as an indication of the Government's commitment to foreign investment, which can eventually be repealed or dissolved when no longer needed. Hence it is a message of welcome more than a necessary law.

The challenge in such laws, however, is in maintaining a level playing field for all investors. FDI laws have been used to attract outsiders at the expense of local investors who do not enjoy the same benefits, thus skewing investment patterns unnecessarily. This challenge can be met in part through awareness by the donor community of the problem followed by advice to local counterparts to ensure the commercial environment is being developed for *all* investors, not just for those with hard currency or new money.

Second, the FDI law has marginal importance compared to the tax and fiscal regime affecting investment. Investors are concerned with their ability to gain a reasonable return on investment over the long-term, and this directly affected by the taxes they are required to pay. Currently, the fiscal structure has a number of seemingly low taxes that in the aggregate are actually quite burdensome. Resources spent on FDI legislation will be wasted if these more fundamental issues are not addressed first.

G. Trade

Trade issues were addressed by a separate study and analysis under a different task order. Our team noted several issues, two of which are addressed here.

First, the trade regime continues to be protective of local industry. There also appears to be much support for this protection at the grass roots level. The breakdown of the old order, in which large companies had pre-arranged relations with suppliers and buyers, has left most of the public enterprises in dire straits. They have been unable to adjust to the market. Fear of bankruptcy and layoffs seem to fuel strong support for protectionism, and may limit the strength and appearance of political will for truly open trade. Highly convincing public education on the benefits of an open trade regime should be considered for all trade programs both to build support for and reduce resistance to reform.

Second, the licensing regime, though simplified, is still a constraint on companies wishing to do import and export business. On the positive side, Yugoslavia has eliminated or simplified the requirements for export and import licenses, so that companies need no longer go through expensive and time-consuming application procedures for commercial import and export licenses. On the other hand, other licenses are still very cumbersome and subject to discretionary application of laws. This results in increased costs, reduced productivity, and can be a tool for

unfair competition by manipulation of the licensing bureaus in favor of one actor at the expense of others.

A number of lawyers who represent local importers and exporters commented on the need for reform in customs as well as substantial training and education. As our team was not addressing these issues, we did not go into any depth but merely note the observations for use by others.

H. Privatization

The Privatization Law, while outside of the statement of work for this task in some respects, nevertheless intruded regularly into discussions of the commercial legal regime. Three issues were significant.

First, the success of privatization will be affected by Company Law considerations. The existence of "social capital" reduces the value of any company by more than just the 30% of the value of the shares represented. Uncertainties over the nature of the ownership also has a negative economic impact. While the government is committed to elimination of social capital over the next three years, many of the more important privatizations are scheduled to take place prior to expiration of social claims. This may be a political cost that has to be paid, but policy makers should be advised on what it is costing them in revenues or investment quality.

Second, the draft Privatization Law is very aggressive in its overall approach, but is insufficiently regulated. The criteria for awarding bids are not properly defined or developed. Unless scoring clear and transparent, the quality of bids and bidders will be compromised, and awards will be subject to unwanted challenges.

Third, the quality of privatization is also subject to the quality of the investment climate. It is essential that the government establish property rights effectively and the mechanisms for ensuring those rights. Thus, the Law on Property, Company Law (with emphasis on minority rights, corporate governance, and registration), Collateral Law, the fiscal regime and other areas must be addressed either previously or in concert with the privatization program in order to attract and maintain the highest quality investment.

I. Property

Our review of property focused primarily on the registration of real estate, immovables, and mortgages rather than the overall legal regime. In depth review of legislation should be done undertaken in the near future in the context of assistance to working groups rather than determination of existing rights. This is because virtually all of the principle laws related to land and land registration are scheduled to be revised, including:

- Property Law of 1978
- Law on Real Estate 1991
- Law on Real Estate Registries 1991
- The Law on Construction Sites

- Central Registry Law
- Law on Privatization
- Law on Privatization Agency
- Law on Denationalization
- Law on Expropriation
- Law on Execution
- Decree on Tender Sale
- Decree on Public Offer
- Decree on Voucher Sale
- Decree on Appraisal Practice
- Decree on Appraisers

Legal issues raised in interviews focused on several specific ownership issues. First, in Yugoslavia, rural land can be owned outright by individuals but urban land is the property of the state. The state issues leasehold interests and rights of use, but not property ownership. Similar systems are used in other countries, most notably England, where 99-year leases on royal holdings are commonplace and highly marketable, having been established over hundreds of years. FRY and Serbia, however, do not have a history on which they can rely with respect to treatment of their commercial obligations. In some ways, they are only 6 months old. Consequently, state ownership claims may detrimentally affect urban development by lowering property values and investment. This is by no means certain, but the government should seriously reconsider its position as a sovereign urban landlord.

For rural land, there are some properties subject to claims of social ownership, particularly land belonging to state enterprises. Such claims are very unclear at present, and therefore very difficult to evaluate in terms of risk of loss. They represent a cloud on title for any potential investor and could adversely affect the revenues received through rural privatization. Eliminating the social claims should be high priority in connection with the privatization program.

The Draft Law on Expropriation presents another area of concern. As currently drafted, it is not clear that current holders of previously expropriated property will not in turn be subject to expropriation. Lessons learned from other Eastern European experiments indicate that claims should be limited to compensation only to avoid significant economic disruption and a chilling effect on new investment in properties subject to claims (which are often very significant properties), unless such properties are directly held by the state and can be returned without disruption. Both approaches produce injustices, but compensation avoids collateral damage to the economy.

In the registries, the principal issues relate to registration of urban land. First, registration of possession slowed during the past decade, so that today the registration books do not adequately reflect the possession or ownership. (Although the land is owned by the state, individuals can own buildings on those lands.) This is particularly problematic in apartment buildings. A large number of buildings have never been registered, so that it is impossible to register the individual apartments.

Complicating the matter, the Land Registry has very burdensome requirements for proving possession and ownership that do not capture lessons learned from best practices elsewhere. Rather than rely on the generally accurate cadastre as the basis of updating registrations, they require numerous documents and attestations that are not needed. Such requirements will add to the a heavy workload once the economy recovers and the land and real estate market becomes more active. Now is the time to establish more efficient procedures.

The market for reform can be expected to be driven by two forces. First, privatization will mean changes in ownership, which must be registered. High-end foreign and local investors are reluctant to make significant investments unless they have very secure ownership rights. Improper registration or difficulties in updating can have a detrimental impact on the timing and quantity of investment. It would be prudent to identify now what problems might be encountered by investors with respect to any entities being privatized.

Second, mortgage lending is expected to return as the banking system and general economy recovers. It will be hampered badly in urban areas by the disconnection between registered and actual ownership. Many unregistered transactions have taken place over the past ten years, leaving a gap in the registered chain of ownership. Banks will not generally lend merely on possession of a property unless some inalienable right to possession can be demonstrated. By establishing the procedures now for updating registration, much delay can be avoided in the future as there is increased demand for registration services.

Mortgages raise an additional issue. The fees charged on registration of a mortgage interest are based on the value of the underlying property, not on the value of the mortgage itself. This can result in serious cost distortions. For example, a $10,000 mortgage on a $100,000 property will be subject to a 2% tax, or $2,000. This represents 20% of the value of the transaction. As a result of this system, mortgages are either overpriced, not registered, or foregone altogether, none of which is an acceptable result. There is also a 5% transfer tax that has a chilling affect on registration and sales. The fee structure needs to be reviewed and revised on a cost-recovery basis.

The land registration system can also be improved and eventually automated. It currently uses an Austrian model for the land book, in which registration is owner-based and not parcel-based. Automation can allow searches by owner and parcel, permitting a shift to the more universally accepted land based system while allowing those who wish to continue using the Austrian approach to do so.

Updating the land books will require proper identification of parcels, which should be based on the cadastre. The registration procedures are also unnecessarily bulky and complicated, and can be simplified based on changes adopted in similar systems elsewhere. This should include development of simplified and standardized forms.